The Evolving Corporation:
Global Imperatives and National Responses
A Study Group Report

Group of Thirty, Washington, DC
The Evolving Corporation:
*Global Imperatives and National Responses*

Published by
Group of Thirty®
Washington, DC
1999
Acknowledgements

The Study Group wishes to thank those who provided editorial and production support for the project, including Susumu Awanohara, Kathleen Lynch and Jeffrey Humin. Thanks are also due to the Bank for International Settlements, the European Central Bank and the Federal Reserve Bank of New York for logistical support for meetings of the Study Group.
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Foreword

Most of the projects undertaken by the Group of Thirty focus on the operation of the international financial system, the risks facing the system and some of the more arcane details of risk management and supervision. While we often publish Occasional Papers on economic issues, trade policy and other features of the real economy, our studies tend to focus squarely on finance.

The study that follows diverges from that pattern. It was the economists among the G30 membership who argued that profound changes have been taking place in large corporations and labor markets, and that these developments merit study by the Group. These changes are being driven by the same forces affecting financial markets to which the G30 devotes much of its attention, but the effects go well beyond the realm of finance to the well being and prosperity of workers and entire economies. Marina Whitman, who has recently written a book on the experience of U.S. corporations, proposed a comparative study across countries and the proposal was adopted. For her initiative, Marina had no choice but to chair the study.

The Group’s reactions to the study group report were extremely positive. The analysis provided important insights into the economic evolution of the last twenty years in the industrialized countries. It begins to explain the mechanisms by which macroeconomic prosperity can coexist with microeconomic uncertainty. While the analysis at this point deals only with G-10 countries, and only a few of those, the importance of the work, and the insights provided, clearly suggested the need for circulation beyond this geographic group. At the same time, the G30 is considering the possibility of a sequel to expand the analysis to additional countries and especially to the challenges of corporate governance facing emerging market corporations.

I commend this thoughtful analysis to all those interested in how economies evolve in response to external economic and financial forces and the pressures of domestic politics. We look forward to further work on the changing face of global corporations and the implications for the welfare of economies and their citizens.

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Preface
Marina v.N. Whitman*

How are major corporations—based in industrial countries with very different cultures, social systems, and institutions—responding to a set of common economic pressures? These pressures include the global slowdown in growth and the increase in economic and financial volatility since the early 1970s, the intensification of competition arising from trade liberalization and domestic deregulation and privatization, and rapid advances in information and communications technology. These forces, together with intensified shareholder demands for higher returns, are driving changes in companies' relations with other groups in society, and these changes, in turn, are forcing major adjustments in the way labor markets function.

The Group of Thirty commissioned four country studies on Germany, Japan, the United Kingdom, and the United States to examine how these common forces are interacting with each country’s highly specific and quite different national environment. An overview, based on these studies and on the deliberations of the study group, addresses two interrelated questions:

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• How and to what extent are these interactions producing convergence toward the model of the United States, where adaptation has proceeded the farthest and the fastest?

• What does this process imply for the future of labor market adjustments in these and other industrial nations?

The study draws some tentative conclusions and identifies areas in which voluntary action by corporations may represent an effective way to address the challenges ahead.

The limitations of this analysis should be kept in mind. The focus of this study is the industrial nations in the so-called Triad (North America, Western Europe, and Japan) and on the behavior of large, internationally active multinational corporations. Since a paper was prepared on only one continental European country, new and innovative approaches being pursued in Denmark, Ireland, the Netherlands, and Portugal, among others, have been left unexamined and might be fruitful areas for further analysis. The study does not address the varied and complex conditions in emerging markets, nor does it explore the dynamics of smaller corporations, family firms, or the self-employed. It also takes a historical perspective, looking at experience of the last 20 to 30 years. But, although the scope is by no means universal, the findings have significant implications for emerging market-economies and raise important questions regarding international governance. This is because the Triad nations still account for the bulk of world trade and investment, and because the pressures described here are truly worldwide in scope. Future studies, it is hoped, will look more specifically at the longer range impacts of current developments affecting companies and on their implications for balanced global development.
I. Overview: The Evolving Corporation

Peter Kenen and Sylwia Ostry

The value of the four papers in this volume derives in large measure from their careful descriptions of the evolution of institutions and outcomes in their countries. The stories told by the papers, however, suggest some broad generalizations regarding the challenges faced by those countries’ corporations and their responses to them.

All four countries faced three fundamental challenges during the last quarter of the twentieth century:

- the deepening integration of markets produced by trade liberalization—the abolition of postwar trade controls mandated by the Organization for Economic Cooperation and Development (OECD), the progressive reduction of tariffs sponsored by the General Agreement on Tariffs and Trade (GATT), and the extension of the trade policy agenda inside the border to cover domestic regulatory and legal systems relating to services and intellectual property—with the resulting intensification of product-market competition
- the sharp deceleration of economic growth and increase of economic and financial turbulence after the collapse of the

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Bretton Woods system and the oil shock of 1973-74 and, with particular intensity in Japan, following the bursting of financial bubbles in the 1990s.

- the rapid advance of technology that transformed methods of production in existing industries, created whole new industries, increased the tradability of services, and revolutionized the management of information and the global span of production.

There were, in addition, major changes in the role of the state. Privatization and deregulation broadened the domain of the private sector. As economic regulation declined, however, corporations were constrained by new forms of social regulation concerned with worker and product safety and with the quality of the environment.

Yet the four countries differed strikingly in the manner and speed with which they adapted to these developments. Remarkable changes in the American corporation, described by Marina Whitman, have transformed its relations with its stockholders, workers, and other stakeholders. There has been less change in the United Kingdom, Germany, and Japan, although it appears to be gathering speed.

Why was adaptation deeper and faster in the United States? How far and how fast will it go elsewhere? We cannot answer these questions decisively, but can perhaps identify some of the principal reasons for the different rates of change and some of the cross-country differences that may prevent or constrain the further convergence of institutional arrangements and actual outcomes across the major industrial countries.

**Different Regimes with Similar Results**

At the start of the 1970s, there were large cross-country differences in the organization of relations between corporations and their chief stakeholders. In Germany and Japan, for example, there were—and still are—close links between banks and corporations. Banks provided a very large share of the external financing sought by corporations, and they held large blocks of stock in nonfinancial corporations. In Germany, moreover, banks have been amply represented on the supervisory boards that elect and oversee the managing boards of large corporations. The banks’ managerial role has been less formal in Japan, but banks have sometimes intervened in their clients’ affairs by “sending their own men as executives,” especially when the companies in question faced financial
problems (Ogata, p.70). There were, in addition, intimate links between nonfinancial corporations—upstream with suppliers in Japan and downstream with customers in Germany—links that were cemented by cross-holdings of shares, especially in Japan. There were no comparable links in the United States or the United Kingdom.

Nevertheless, the managers of corporations enjoyed a great deal of autonomy in all four countries under study—an autonomy protected by deference to seniority and a strong presumption of long-term job tenure for managers as well as workers. In Japan, large companies were managed by self-perpetuating corporate bureaucracies. Executives were hired initially right after they graduated from university and promoted thereafter to managerial and executive positions after long years of service. Arrangements were less rigid elsewhere but did not appear to be dramatically different from those in Japan.

In labor relations, the four countries had very different regimes at the start of the 1970s. Labor unions were relatively weak in the United States and have grown weaker, except in the public sector. Except for brief periods in the 1930s and after World War II, the prevailing philosophy of the American union movement—sometimes termed Comper-ism after the founder of the American Federation of Labor—has been pragmatic, not ideological, and hence adaptable to changing circumstances. Unions were much stronger in the United Kingdom, due to a long history of adversarial labor relations and to postwar legislation. Unionization is widespread in Japan, but Japanese unions are company unions, very different from those in other countries. They tend, says Ogata, to identify closely with the interests of their firms, not those of the union movement, and are chiefly concerned with job security and working conditions rather than nominal wages. They do not seek to participate in management. In Germany, by contrast, employees hold half the seats on the supervisory boards of large corporations, and unions hold some of the seats reserved for employees. Collective bargaining takes place at the industry level, though in individual states or regions, not on a national basis. Wage rates negotiated in this way are regarded as minimum wages and apply to nonunion workers as well as union members. Works councils in individual plants deal with certain nonwage issues.
These very different industrial relations regimes were reinforced by government policies, not only in the field of industrial relations—such as the rules governing collective bargaining, union organization, etc.—but also employment protection, unemployment insurance, welfare benefits and so on, which amplified the differences among the regimes. In some respects, however, these different labor market arrangements did not yield very different labor market outcomes. Here is how Whitman describes the situation in the United States before it began to change:

The old social contract, as most Americans understood it, had four major characteristics: permanence in the employer-employee relationship; entitlement, not only to a job but also to steady pay advancement and generous benefits; paternalism, in the form of a shared view of employees as part of a company "family"; and hierarchy, such that lines of authority and levels of status were clearly defined within the firm and carried over into the outside world (p. 41).

Nearly identical language could be used to describe the Japanese system of lifetime employment, although seniority and attention to on-the-job training played a more important role in large Japanese firms.

There is, however, one significant difference in labor market outcomes, which the authors do not mention, although it deserves underlining. Even in the early decades after World War II, wage or income disparities were much wider in the United States than in the other countries, and they have become even wider since the 1970s.

The papers in this volume examine the role of government in the four countries studied. Government, for these purposes, includes actions of the executive and the bureaucracy as well as political processes, which vary considerably among the countries. The papers emphasize the different roles government has played in the four countries. The Japanese government managed the market in cooperation with Japanese firms and banks. The German government supported and reinforced corporatism, social cohesion, and the welfare state. In both the United Kingdom and, to a lesser extent, the United States, various forms of economic regulation constrained market forces. Yet despite these differences in the role of government and in labor market regimes, there appeared to be more similarity than difference in corporate governance. In the United States, managers were in control because stockholders were passive. In Japan, managers were subject to governmental guidance and in
Germany, to codetermination. But in all the countries, managers were able to forge a similar social contract and deliver similar benefits to their workers.

**Similar Challenges and Different Responses**

In the 1970s, every industrial country faced the challenges listed at the start of this paper. During that decade, however, and to an even greater degree in the 1980s, the American corporation changed in the dramatic ways described by Whitman, but there was less change elsewhere. American corporations altered the organization of work, adopting new practices perfected in Japan. By the end of the 1980s, moreover, they had overhauled the implicit contract between firms and workers. Previously, core workers were laid off temporarily in periods of slack demand, but firms began instead to cut back core employment and to deal with periods of peak demand by hiring part-time and temporary workers. Pay was tied more tightly to performance—the performance of the individual worker and that of the whole firm—and tied less tightly to seniority, and earnings dispersion increased within and between different categories of employees.

It was easier to make changes of this sort in the United States than in other countries. Unions were relatively weak in the United States, and formal labor market arrangements were less firmly supported by government policies. In the United Kingdom, trade unions resisted significant changes in the organization of work and any derogation from pay based on seniority. The implicit contract between firms and workers could not be revised until the Thatcher Government had acted decisively to alter the balance of power between firms and unions. In Germany and other continental countries, it is still costly to change the organization of work and to cut core employment. In Japan, the implicit social contract within the firm is deeply embedded in the Japanese economy, society, and polity. Ogata puts it this way:

The corporate structure and practice... seem to be based on the group consciousness that prevailed in Japan during the postwar years. Among the factors supporting such group consciousness were:

- ethnic homogeneity
- paternalism, according to which even members of large companies see themselves as one family
- a strong sense of shared purpose—such as growth and continuation of their companies—among employers and employees

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• a relatively narrow income gap between top executives and ordinary employees
• upward mobility of labor without stark social-class distinctions (p. 67).

But the differences in specific institutions—for example, industrial relations regimes—provide an inadequate answer to the puzzle posed here: similar challenges and different responses. The full configuration of institutions affects how each institution functions. Thus, the industrial relations regime is influenced by and has influence on financial markets and corporate governance. Put another way, institutions are embedded in a system, and the system includes both explicit rules and regulations designed by governments and implicit rules of behavior, which have deep historical roots and evolve incrementally over time. Thus, a system that may operate effectively in one environment can run into the ground in another. Moreover—and most important—a system that functions superbly when change is incremental and moving in established, predictable channels may do that precisely because it has features that constrain its adaptability to pervasive and rapid change. Hence, the system that is most flexible will beat its competitors in a dynamic environment but cannot deliver the stability, predictability, and cohesion furnished by the social norms of the more rigid systems.

Whitman’s account of developments in the United States illustrates how the institutional system mediates the impact of external change. She points out that product-market pressures from below were far stronger in the United States than in Japan or Germany—though not perhaps much stronger than in the United Kingdom. In addition, financial market pressures from above were extremely powerful in the United States but virtually absent elsewhere.

In the 1950s and 1960s, the United States was the world’s only economic superpower. But Japan and Germany were catching up quickly. Hence, the process of trade liberalization and product-market integration had asymmetric effects. American firms were more suddenly and sharply exposed to international competition. In Japan, moreover, the effects of product-market integration were attenuated by opaque trade barriers and by covert subsidies. In Germany, they were attenuated by the completion of the Common Market; the preferential treatment accorded German goods by other Common Market countries offset in part the intensification of international competition resulting from the Kennedy and Tokyo Rounds of tariff cuts.
We do not mean to minimize the importance of the point made by Fels, Matthes, and Schnabel, that German firms stressed product quality to offset high German wages. We simply suggest that other conditions helped to explain why German firms were less intensely affected by competitive pressures than were American firms.

All of these developments, together with the slowdown in the growth of productivity in the 1970s, the increase of economic and financial volatility, and the overconfidence of U.S. corporations, born of their earlier dominance in domestic and foreign markets, account for the sharp decline in the profit margins of U.S. firms, emphasized by Whitman. One must also recall, however, the huge appreciation of the dollar in the early 1980s, which handicapped producers of tradable goods in their own and foreign markets.

While these things were happening on the goods-market side, something else was happening on the asset-market side of the U.S. economy—the advent and rapid growth of pension funds, mutual funds, and other institutional investors, which began to exercise pressure from above. This is how Whitman puts it:

Around the middle of the 1970s, the trend in the United States toward increasing separation of ownership from control began to reverse itself. For the thousand largest firms in terms of market value, the share of publicly held stock owned by pension funds, mutual funds, and other large institutional investors rose from 16 percent in 1965 to 57 percent in 1994. As their ownership of corporate America grew, institutional investors exercised their new power in a variety of ways. In particular, they played a major role in the development of the market for corporate control that emerged in response to the profit-erosion and resulting collapse of stock prices in the 1970s.

Frustrated by these developments and empowered by economic deregulation and a more relaxed antitrust environment, financial innovators sought new ways of wringing improved financial performance from companies that had grown complacent and unfocused. The result was an unprecedented wave of mergers, breakups, hostile takeovers, and leveraged buyouts in the 1980s. In their efforts to enhance investor returns and portfolio values, institutional investors used their funds, their shares, and their shareholder votes to facilitate such transactions.... Executives of companies with disappointing earnings or sagging stock prices, and even of companies that were doing well, felt their positions threatened along with the very survival of their firms (p.36).
To which we would add one observation. Institutional investors and the individuals who manage them are locked in intense competition to raise the volume of funds under management on which their own earnings depend and thus to outperform their rivals.

Although we have given some reasons for believing that the challenges and shocks of the 1970s had asymmetrically intense effects on American corporations, they were not without effect elsewhere. Why, then, were there not similar changes in the attitudes and influence of German and Japanese shareholders? We have already mentioned one obvious reason. Large blocks of stock are firmly held by banks and corporations. Furthermore, pensions provided by German and Japanese firms are financed in large part from retained earnings reinvested in the firms themselves, not from segregated, diversified pension funds. For their part, moreover, banks and nonfinancial firms that hold large blocks of stock hold them for different reasons from those of institutional investors in the United States. Their holdings serve to cement long-term business relationships: creditor-debtor relationships in the case of banks; supplier-customer relationships in the case of Japanese firms. (Ogata points out, moreover, that cross-holdings of shares in Japan also protect Japanese firms from foreign takeovers.) In other words, these shareholders, unlike professional investment managers, are less concerned about rates of return or portfolio values than preserving the basic business relationships symbolized by their share holdings.

Before moving to a discussion of convergence, let’s recall the central argument of this introduction, namely that the answer to the puzzle posed by the four country studies—why similar challenges evoked different responses—lies in the differences in institutional systems. In a period of ongoing and pervasive change in the external environment, institutions mediate the impact of that change and hence the pace and nature of adaptation. The term system is important because the full configuration of institutions affects how each institution functions.

In a period of ongoing change, the most flexible system comes out on top. The contrast between the United States and Europe, for example, has been characterized as a contrast between Exit and Voice, a metaphor adapted from the work of Hirschman. An Exit paradigm is far more adaptable in a period of rapid change because social change is governed by an anonymous mechanism that rewards
the most efficient—winners prosper and losers appear to disappear. A Voice paradigm, by contrast, gives losers influence. Governments must then engage in a long and difficult political process to renegotiate the social contract: “rigidities” that were not terribly important when growth was high and moving in established channels become powerful impediments to adaptability at a time of pervasive change. In Japan, the Voice may be quiet and discreet, and the conversation takes place behind closed doors in many different rooms. But Voice it is, and Exit is very difficult to arrange.

So institutions matter—a fact that many economists are beginning to acknowledge. But our analysis also suggests that institutions mediate differently. In response to the major changes of the last quarter century, including the deepening integration of the global economy and the revolution in information and communication technology, the financial markets have served as a “catalytic” institution. In the United States, it was the shift to shareholder capitalism that precipitated the pressure for change in the corporation and consequently in other interrelated institutions. Will capital markets play the same role in Europe and Japan? Certainly, the surge of mergers and acquisitions in Europe and the growing role of American shareholders in European firms are propelling a restructuring much like the one that took place so much earlier in the United States. The long recession in Japan is finally forcing change (if modest) in government policy and corporate behavior, and the restructuring process has attracted a flock of foreign investors to the Japanese stock market.

Yet the questions remain. Will one corporate governance model become the global standard? Will it be the American model or some hybrid? And since the institution of corporate governance is embedded in a complex institutional system of both explicit governmental laws and regulations as well as deeply rooted codes of behavior, a universal Exit paradigm may not emerge, even if shareholder capitalism rules the world, because of a key difference between the American system and that of other countries, with the possible exception of the United Kingdom. The United States is different not simply because earnings disparities are larger, but also because of a greater American tolerance for inequality.

This difference is important for two reasons. First, as noted above, structural adjustment produces winners and losers and is easier if the losers have little voice, because they cannot attract
widespread political support. Second and more important, the new technologies are high-skill biased so that income disparity is endogenous to the technology trajectory. The ascendance of this tolerance for inequality in the United States is well documented in an article published in the spring 1999 Brookings Review. Data from polls in the 1960s and in 1998 measure not only a decline of trust in government (which is widespread in most OECD countries), but also in a diminished support for governmental programs aimed at reducing differences in income. While no comparable data exist for Germany and Japan, the country studies for them show that social cohesion is a primary value and strongly linked to concepts of equity in income distribution.

Yet ongoing changes in technology and in the global economy ensure that the pressures for convergence will not soon abate. At the same time, however, globalization has become a synonym for Americanization, and "globophobia" is on the rise in both Europe and Asia. The heart of this globophobia is fear of labor-market changes—the American flexible model. There is thus an increasing tension between the pressure for change and the fear it engenders, and that tension may breed international friction, which is most likely to manifest itself in the trade policy domain. So what are the prospects for convergence and what could be done to mitigate the tension already manifest within many OECD countries?

Prospects for Convergence

Can we expect the major industrial countries to converge on a model resembling the one that has been developing in the United States? What forces are pushing them in that direction? How much resistance will those forces encounter in individual countries, due to deep-seated differences in institutions and values?

The stories usually told about globalization focus on the homogenizing influence of international capital mobility, including the great growth of foreign direct investment in emerging market-countries, and the revolution in information management that helped to make it possible. That list is too short, however, and gives too little weight to important two-way relationships. The growth of foreign direct investment in emerging market-countries, for example, has helped to reinforce the pressures coming from below—the deepening and broadening of goods-market competition that has been forcing
corporations in the major industrial countries to alter their implicit contracts with their workers. To some significant extent, however, the increase of direct investment in emerging market-countries testifies to the strength of the institutional constraints that make it hard for German and Japanese firms to modify domestic labor market practices. German firms have invested in the Czech Republic, Hungary, and other Central European countries precisely because they have no other easy way to reduce their labor costs. They are less strongly attracted to eastern Germany because they face the same labor market rigidities there that they face in western Germany. That is one reason capital formation in Germany has been very low, depressing the overall growth rate of the German economy. Japanese firms have invested in other Asian countries for similar reasons, but their incentive to do so was strongly reinforced by the appreciation of the yen in the early 1990s. Thus, the spread of foreign direct investment to the emerging market-countries is a result as well as a cause of the intensification of product-market competition.

As for the pressure from above—the reuniting of ownership and control resulting from the change in shareholders' behavior—it may be due primarily to the internationalization of the financial services industry and only secondarily to the increase in capital mobility per se. Casson and McCann emphasize this point. The transformation of the City of London began with the development of the Eurocurrency markets—which was not due to the increase of capital mobility but rather to restrictions on capital mobility imposed by the United States in the 1960s (and to the interest-rate ceilings that kept U.S. banks from attracting foreign deposits). The growth of those markets, in turn, led foreign banks, including American banks, to migrate to London—and thus led to the internationalization of the financial services industry. The stimulus given to foreign exchange trading and the growth of the Eurobond market, along with deregulation, attracted other institutions, including investment banks and securities firms. These have played a major role in the development of pension funds, mutual funds, and other intermediaries, which have begun to behave like their American counterparts.

Similar developments are starting to occur in Germany and other continental countries. In fact, Fels, Matthes, and Schnabel attribute the beginnings of shareholder activism in Germany to the growing influence of institutional investors created or inspired by
Anglo-Saxon sponsors. Events in Japan are moving in the same direction, where shareholders have an even more powerful motive for exerting influence on nonfinancial corporations—the very low levels of interest rates and corporate dividends due to the deep recession. Furthermore, institutional investors based in the United States are extending their reach and influence. In Whitman’s words:

Some of the strongest leverage for improved governance practices abroad comes from American institutional investors, some of whom are exporting their techniques of shareholder activism as they expand their holdings of non-U.S. equities (p. 39).

Pressures from below and above—from product and capital markets—are having visible effects in Germany. Wage bargaining used to take place almost exclusively at the industry level, and works councils at the local level dealt with a narrow range of issues pertaining to the organization of work, but there has been a significant increase in the use and scope of “opening clauses” under which matters previously decided by collective bargaining at the industry level are being turned over to works councils and local management—including in some cases modifications in basic wage rates.

Looking ahead, there are reasons to believe that German corporations will experience increasing pressures from below and from above, thanks to monetary union and its indirect effects. The introduction of the euro is likely to intensify product-market competition within the European Union (E.U.) by making it harder for firms and their distributors to charge different prices in different E.U. markets. (Proposals to liberalize “gray market” trade—unauthorized cross-country arbitrage in brand-name goods—would work in the same direction.) Furthermore, monetary union is likely to reduce the traditional role of banks by broadening and deepening the corporate bond market. Hence, German banks will have less influence—and less reason to exercise influence—over the affairs of nonfinancial corporations. This, in turn, will increase the opportunity cost of retaining large share holdings in those corporations, which should make more shares available to other institutional investors. The growth of those institutions, moreover, may be accelerated by the cross-country integration of stock markets. While most recent mergers by European banks have occurred between banks within a single E.U. country or, in the case of Deutsche Bank, with a non-E.U. partner, cross-country links between stock markets are developing rapidly. Over the medium-term, as pension funds are
diversified, pan-European institutional investors will expand and deepen stock markets in the euro zone.

The emergence of some form of shareholder capitalism in Europe may also be fostered by a new wave of nonbank mergers, both intra-E.U. and with non-E.U. firms. The deregulation of telecommunications has played a role in pushing consolidation, but intensified global rivalry in both manufacturing and service industries has also played a powerful role. The migration of American buyout firms and investment banks to Europe, as well as the recruitment of American executives and the popularity of American business schools, recall the 1960s critique by Jean-Jacques Servan-Schreiber in his book *Le Dilemme Américain* [The American Challenge], which described the export of American management and industrial organization—Ford-ism—to Europe. The diffusion of knowledge is a powerful factor for change, and the export of institutions, both formal and implicit, is hardly a new phenomenon.

Whether shareholder capitalism is likely to emerge in Japan is harder to predict. In the unlikely event of an early and vigorous recovery from the current recession, old habits may survive and reassert themselves. The organization and functioning of the Japanese financial system may not change much. There may be some shift by corporations from bank loans to bond and equity issues, reducing the banks' influence on corporate behavior. Changes in corporate accounting rules may reduce the incentive for Japanese firms to hold onto their shares in other firms; they will no longer be able to conceal their capital gains (and losses). Even if business conditions improve, however, firms may still want to huddle together in tight defensive alliances and to hold onto the shares that cement those alliances. If the recession drags on, they may have stronger reasons to huddle together, but they may experience pressures from abroad, rather than pressures from above. They may have to acquire foreign partners, as in the case of Nissan, and these partners may require Japanese managers to make drastic changes in their policies and practices.

In both countries, however, deeply embedded values are likely to prevent full convergence to an American model. Fels, Matthes, and Schnabel remind us that corporations are viewed quite differently than in the United States or the United Kingdom:

*Firms are regarded as social institutions, not just as the property of their shareholders. Employees, trade unions, and*
various other stakeholders have a strong say in corporate
governance and in labor relations through legal requirements
for power sharing and through the traditional principle of
consensus-seeking (p.84).

Although the capital market may catalyze change, that change
will be affected by a more complex configuration of rules and
values.

In Japan, the situation is similar. Although the social role of
the corporation is not defined formally by law, the implicit contract
between firms and workers is part of the larger social compact that
maintains the cohesion of Japanese society.

In both countries, moreover, the American model is commonly
blamed for the much larger dispersion of incomes in the United
States and, to a lesser degree, in the United Kingdom, and for the
much larger numbers of persons living below the poverty line. As
noted earlier, the most robust conclusion of the many studies on
competing models is the strong association of American labor
market institutions with wider income disparity, both within and
among occupational groups. This tendency to widening disparity is
enhanced by the increased elasticity of import supply for goods
and services resulting from globalization, which, in turn, increases
the elasticity of demand for domestic products and hence labor. In
flexible markets with weaker unions and less government, workers
fearful of job losses, are willing to trade wage gains for greater job
security. Only the most educated and most skilled, who are also the
most mobile, can command the highest rewards, and the mobility of
the “winners” adds to their bargaining power. In sum, globalization
involves a continuing pressure for increasing income disparity, and
the system with the greatest tolerance for inequality will have a
distinct advantage. In both the German and Japanese systems, by
contrast though in different ways, equity is a prime social objective,
and “flexibility” would require change not only in the labor market
but also in other institutions and in social norms and values.

This is not to argue that greater labor market flexibility is not
required in both Germany and Japan. Indeed, as noted in both
country papers, incremental adaptation is underway. But more
needs to be undertaken. Like many other German economists, Fels,
Matthes, and Schnabel emphasize strongly the adverse effects of
certain labor market practices—the high costs of dismissing workers—
which deter German firms from hiring new workers, the powerful
role of "insiders" who make wage bargains that benefit those who have jobs and penalize those that do not. We would also stress the effects of labor market rigidities on capital formation and the resulting tendency of German firms to "export" potential jobs by investing in neighboring countries rather than Germany. And these effects are reinforced by another phenomenon emphasized strongly in the country papers—the relative abundance of venture capital in the United States. While Whitman is right to reject the view, widely held in the United States, that small firms account disproportionately for the creation of new jobs, the survival, success, and subsequent growth of small American firms, especially in new industries, may be due in no small measure to the relative abundance of venture capital. Many small firms fail. But many others prosper and can offer well-paying jobs to large numbers of skilled workers.

Once again, the full institutional configuration should be the focus of policy analysis, and it leads us to conclude that Germany and Japan are unlikely to embrace the American model in all of its dimensions. The restructuring of financial markets in Europe brought about by monetary union will perhaps result in the reunification of ownership and control, producing pressure from above for more responsive management. It is unlikely to induce labor market changes of the sort that have occurred in the United States. Japan may be slower to change, despite some promising signs of adaptation, and there may be retrogression when the recession ends. There is no risk of that in the United States, but there is another risk, strongly stressed by Whitman, that the United States will turn to trade protection.

Trade Friction
There are few signs of rising protectionism in the United States at present, despite the enormous increase in the current account deficit. This is in marked contrast to the situation in the mid-1980s, when an overvalued dollar and a rising trade deficit spawned a wave of protectionist fury in Congress and in many sections of the business community. Indeed, it was that rise in protectionist sentiment which induced the Reagan administration to launch the Uruguay Round, and it also played an important role in mobilizing support for the negotiations by export-oriented multinational enterprises (MNEs) in the services and high-tech sectors. Today, there is little evidence of strong American leadership, either from the government
or the major MNEs, to reinforce and sustain the multilateral trading system, housed in the World Trade Organization (WTO).

The curious lack of protectionist fervor—apart from the usual rise in steel antidumping cases—may be due to the full employment economy. As growth slows, the picture may darken. And the extraordinary leadership role of American MNEs in the Uruguay Round was perhaps unique because it reflected the strongly held view of those corporations that the GATT system required radical redesign to include trade in services and intellectual property (America being the world leader in most service sectors and in high-tech). If the GATT system could not be redesigned, then bilateralism and regionalism were the preferred options. Whatever the reason for the present leadership vacuum, it is unprecedented. The United States played the leading role in the formation of the GATT and in every GATT round of negotiation since 1948.

It is not only the leadership deficit that makes the trade policy ambience today so uncertain. There are serious trans-Atlantic differences over genetically modified foods and on the scope of the negotiations. But by far the most divisive issue on the horizon concerns what trade economists now call the “trade and...” issues: environment and labor standards. While the Uruguay Round was a game played mainly by governments and business, the best prepared and most active players today are the nongovernmental organizations (NGOs). Emboldened by their success in the defeat of the OECD’s negotiations on a Multilateral Agreement on Investment (MAI), the NGOs, especially the “greens,” are demanding major change in the WTO mandate and procedures. Neither the United States nor the European Union are prepared to antagonize these new players—in part because of domestic political pressures—but most developing countries are adamant in their opposition to consideration of both “trade and...” issues since they consider them to be protectionist in either intent or consequence.

The familiar bicycle thesis of American trade analysts calls for regular large-scale multilateral negotiations to stave off the ever-present latent protectionist pressures. On this view, the absence of overt protectionist signs at present should not lead to complacency. An ambitious full-scale round is essential or the bicycle will fall over, and U.S. support for a liberal trading system will be seriously weakened. Although not everyone fully agrees with this thesis, other powerful reasons, especially the proliferation of regional
agreements, argue strongly for a renewal and reinforcement of the multilateral system by both a new round of negotiations and a major effort to reform and reinforce the WTO as an institution. Another way of mitigating "system friction" is more directly related, however, to the evolving role of the corporation.

From Macro to Micro Focus

What will emerge from the new negotiations on the environment and labor standards is impossible to forecast, but compromise seems more likely on the former than the latter. Whatever the outcome, it will not resolve fully the underlying issue: how to draw the boundary between international rules governing the trading system and domestic social policy. Thus, following a parallel policy route would be useful—relying on transparency and self-regulation at the corporate level.

The Asian financial crisis has spawned a number of initiatives to improve transparency by formulating standards or codes of good practice, both for governments and corporations, especially in the financial sector. Crisis prevention, not corporate governance per se, was the aim of these initiatives, promoted by the International Monetary Fund, the Bank for International Settlements, and other institutions, although the impact of harmonizing accounting standards will be pervasive and compelling, especially in Japan. Our main point, however, is that the full and active engagement of the private sector in both policy design (developing codes of good practice) and implementation (monitoring and sometimes self-regulation) represents a major innovation in the policymaking process. This innovation is likely to expand and deepen the linkages between the regulatory activity of governments and the voluntary self-regulatory activity of market actors—with increased transparency as the principle catalyst.

While the financial crisis and its aftermath garnered all the headlines, similar developments have taken place in the area of corporate governance per se. Codes of good practice have also been developed to deal with environmental issues and, though in a different manner, labor standards. These are directly relevant to our main themes—competing models and convergence.

In spring 1998, the OECD ministers adopted a report entitled Principles of Corporate Governance, prepared by experts from the private sector in the United States, Germany, and Japan. The
principles, though nonbinding, are clearly intended to promote “best practices” by individual corporations as well as member governments. Although the shareholder-stakeholder debate is left unsettled, a brief section is included on the role of stakeholders “as established by law,” and the report also states that “even in areas where stakeholder interests are not legislated, many firms make additional commitments to stakeholders, and concern over corporate reputation and corporate performance often require the recognition of broader interests.”

In July 1999, the OECD and The World Bank announced a joint initiative to promote the OECD principles in emerging markets.

This corporate governance project is only one part of a broader OECD micropolicy initiative. With the demise of the MAI, the OECD decided to update its 1976 Guidelines for Multinational Enterprises. Since these guidelines were designed to provide a benchmark for “good corporate behavior,” the update exercise provides an opportunity to tackle environmental and labor issues (as well as to combat corruption by including material from the OECD’s legally binding Anti-Bribery Convention). It is also aimed at engaging the NGOs, in an effort to achieve a broad consensus. The approach thus recognizes a shift of power to NGOs, produced in part by the internet, which can make transparency a powerful agent for change. Consumer activism directed at changing the behavior of corporations is potentially a powerful instrument in fiercely competitive global markets. Transparency and the internet might also increase the influence of institutional investors who have established “ethical” or “green” funds.

The environmental guidelines will likely be borrowed from the International Standards Organization’s ISO 14000, issued in 1997. These management guidelines, developed mainly by business experts but with some NGO participation, are intended to minimize harmful effects on the environment caused by a firm’s activities. The guidelines are voluntary, but national accreditation bodies may provide certification, and industry associations usually play an active role in this process. If incorporated into the OECD’s MNE guidelines, an additional avenue for implementation will be provided.

On the labor standards issue, the situation is less clear-cut and far more contentious in developing countries. There is no set of ISO principles that could be transferred to the MNE Guidelines. In 1997, however, a Presidential Task Force established a code for
American apparel firms at home and abroad, and a U.S.-based NGO, the Council on Economic Priorities, has issued a labor standards code entitled SA 8000. Although neither of these operations enjoys the substantial global support and technical infrastructure that sustain the ISO, they may be promising prototypes.

It is far too early to tell whether this new micropolicy approach will significantly change corporate governance and corporate behavior. The outcome will depend on how these voluntary codes affect the bottom line, and this will depend not only on public awareness but also on the role of financial markets. The impending harmonization of accounting standards will have a significant impact on corporate governance. If financial markets continue to define shareholder value in traditional terms, however, new guidelines for “responsible” governance will have less rapid and pervasive influence, despite their possibly significant impact on individual firms and industries. Yet this new policy innovation is worth monitoring. It will not result in convergence but is likely to reduce divergence. And it may be a promising way to involve NGOs in policy formulation and implementation—of encouraging them to pursue their important objectives without threatening the integrity of the multilateral trading system. It will certainly have a global impact by affecting the evolution of multinational corporations wherever they are based.
Notes


II. From Stability To Flexibility: American Corporations and The U.S. Labor Market

Marina v.N. Whisman

Nowhere has intensified competition, combined with a sharp increase in shareholder demands for higher returns, had as pronounced an impact on corporate behavior as in the United States. The effect has been to shift power from the managers of large corporations to consumers and investors. And the pressures created by this shift are driving changes in companies’ relations with other groups in society, with a particular impact on the implicit contracts between employers and employees that shape labor markets.

The Corporation Then and Now

To understand how profound the changes have been in its relationships with workers, managers, and the larger society, we must first recall how the prototypical large American corporation of the 1950s and 1960s looked, before the post-1973 global economic environment of slowed growth, increased volatility, and expanding

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interdependence undermined its foundations. These firms were characterized by stability, global dominance, uniformity, and shared gains. Admirers and detractors agreed that the definitive external characteristic of these organizations was their economic power, while their chief internal characteristic was the almost unlimited discretion of their managers to set the goals and priorities they pursued.

Large corporations did indeed account for a substantial share of American economic activity. In the 1950s, the 13th-odd largest manufacturing corporations accounted for half of U.S. manufacturing output, and the 500 largest business corporations accounted for nearly two thirds of all nonagricultural economic activity. These firms dominated economic activity abroad as well. The United States led the world in its share of global output and exports, which in 1960 amounted to some 40 percent and 20 percent, respectively. It also led the world in technology, as evidenced by a productivity level twice as high as Europe’s and four times higher than Japan’s, and maintained this lead by devoting a far larger share of resources to technological progress than did any other nation.

The large corporations, whose achievements made American technology and American efficiency a standard for the world to follow, appeared to be well-nigh immortal. Year after year the same names topped the Fortune 500 list of the nation’s largest industrial corporations, and shares of such firms as AT&T, General Electric, General Motors, and IBM were dubbed “widows and orphans’ stocks” because they were virtually guaranteed to earn profits and pay dividends regularly year in and year out.

With this stability and global economic dominance went corporate power, power that was a subject of discussion and concern among academics, journalists, government officials, and the American public. A major manifestation of this concern were threatened or actual antitrust actions that resulted in the breakup of AT&T into eight separate companies and imposed significant constraints on the operations of such firms as General Motors and IBM. Sheer size and the scale of resources at their command is only a partial explanation of the power of such large firms and the broad discretion accorded their management to use corporate resources to pursue a variety of goals instead of focusing single-mindedly on maximizing profits. In addition, they were unconstrained either by competition, as a result of their oligopoly power, or by the capital markets, as a result of their internal financing and the passivity of their shareholders.
Americans may have mistrusted the power of the large corporation in its heyday, but they had also come to depend on it—and on the managerial freedom that accompanied it. The men (and they were all men) who headed the nation's major corporations shared the gains from market power (economic rents, in economists' parlance) far more widely than is generally recognized. Most people associate such rents with large profits, high executive pay, lavish perquisites, and organizational inefficiencies, often including redundant layers of management and high overhead costs. But that picture, though frequently correct, is by no means complete.

Rank-and-file workers also shared in these economic rents in the form of secure jobs, wages well above the average for people with similar education and skills, and guaranteed pensions and other benefits. Less obvious are some of the other beneficiaries of large companies' rent-sharing activities. These included: generous contributions to charities, culture, and the arts; corporate leadership in volunteer activities and local economic-development programs; and the expenditure of substantial money and effort on research more beneficial to an entire industry or society at large than to their own bottom lines.

In addition to the gain-sharing they undertook voluntarily or as a result of negotiated union contracts, large corporations have assumed further obligations imposed by government regulations mandating safer products and workplaces, a cleaner environment, a more diverse workforce, and a variety of other social responsibilities. This conversion of private firms into multipurpose social institutions made it possible for the United States to have its cake and eat it too, to provide many of the services of the modern welfare state without a corresponding expansion of government power and government expenditure. In fact, government spending represents a smaller share of total economic activity in the United States than in any other major industrial country.

Pension and health benefits that in most other countries took the form of government (tax-financed) social-insurance programs were instead provided privately for most workers employed by large corporations. In place of government-mandated restrictions on the hiring and firing of workers, American labor markets were governed by voluntary and implicit social contracts—sometimes rendered explicit through collective-bargaining agreements—that implied a reciprocal lifetime commitment between employers and workers (again, the fortunate minority employed by successful
large firms). Finally, the arts and culture, supported in Europe primarily by direct government grants, drew most of their support in the United States from tax-deductible private contributions, many of them donated either directly by the country’s leading corporations, by foundations established by the firms’ founding families, or raised through the volunteer leadership of their top executives.

The capacity of the large American corporation to succeed competitively, to turn out a continuously improving stream of products, to earn steady and reliable profits, and to share widely the fruits of its success helped to make such firms socially and politically acceptable. What few recognized, however, was that the kind of “socially responsible” behavior that made economic power acceptable in the eyes of the American public depended for its very existence on that same market power. Once that power was undermined by a variety of forces, it became increasingly difficult for most large American corporations to sustain all the commitments that the public had come to expect of them.

The safe, comfortable world that large American companies both enjoyed and created for their various constituencies in the 1950s and 1960s was shaken to its very foundations by the economic upheavals of the 1970s and 1980s. Companies that had teetered on the brink of bankruptcy or takeover, or even gone over the edge, changed because they had to. Those that remained intact and successful changed, too, convinced that drastic change was required if they were to continue to thrive.

The stability that had characterized the preceding decades was gone. Whereas only about 4 percent of the Fortune 500 had turned over annually in the 1960s and 1970s, this percentage had doubled by the 1980s. Fully one third of 1980s Fortune 500 companies no longer existed as independent entities in 1990, and another 40 percent had disappeared from that elite list by 1995.

Companies facing external threats also responded by profoundly altering their internal structures. Traditional hierarchies were flattened by eliminating multiple layers of management (and, often, the managers who had occupied them) and replacing rigid reporting structures with more fluid networked or matrix relationships. A newly intensified focus on efficiency, productivity, and cost-cutting led to a wave of what has been called downsizing, restructuring, reengineering, and right sizing—all terms that signify getting rid of people.
One result of these changes has been sharply altered attitudes on both sides toward the employer-employee relationship. The “good corporation” of the 1950s and 1960s assumed mutual cradle-to-grave loyalty. Workers who remained at a single company throughout their careers could expect job security, steadily rising wages, good benefits, and guaranteed pensions. Today, the employment relationship is increasingly assumed to be contingent rather than permanent. Young people expect to change jobs or even careers several times, and two forms of nontraditional employment—temporary employment and contracted-out business services—are the fastest-growing employment sectors. The assumption of job entitlement has given way to an emphasis on performance and personal responsibility for one’s own career. And the proportion of workers who receive guaranteed, noncontributory health and pension benefits is steadily shrinking.

If workers have become more footloose, whether voluntarily or involuntarily, so have the companies that employ them. Increasingly, hometown companies that were mainstays of their communities have given way to absentee ownership located in another state or, often, another country. Shifts to such absentee ownership have often meant reduction or elimination of jobs in the company’s original community. But even when jobs have stayed put, the company’s role in the community, and that of its management, have almost inevitably changed. An executive who heads what is now a division of a larger company headquartered elsewhere is unlikely to have the same motivation, or the same leeway, to use company resources for gain sharing and community leadership.

Even when ownership has not changed, the freedom of top executives to pursue goals unrelated to the company’s bottom line has been circumscribed. Competition is stiffer, consumers choosier and more demanding, and profit margins thinner than when managerial capitalism was in ascendancy. And shareholders are far less passive than they used to be; dissatisfied owners are no longer willing simply to keep quiet and sell their stock. The pace of corporate takeovers, leveraged buyouts, and breakups aimed at increasing shareholder value accelerated markedly beginning in the early 1980s. More recently, institutional investors have used jawboning and publicity to force improvements in financial performance, reforms in corporate governance, or both, while market-analysts keep a laser-bright beam trained continuously on firms’ quarter-to-quarter performance.
While economic deregulation, together with globalization and technological advance, has been increasing the range of economic activities exposed to market competition since the 1960s, the scope and cost of "social regulations," affecting both the products and the processes of American business, have been expanding. Thus, the regulatory requirements imposed on corporations by government have grown even as management's freedom to focus on goals other than profit-maximization have shrunk. Large American corporations, in other words, have become overcommitted. The public functions they assumed in an era of market dominance and market power are colliding with the twin realities of increased competitive pressures and newly aggressive shareholder demands. The result has been difficult trade-offs, disappointed expectations, heightened public and political sensitivities, and a search for scapegoats, making large companies and their senior executives particularly conspicuous targets.

Unquestionably, the upheavals experienced by corporate America and its stakeholders were in many instances made more severe by complacency, myopia, arrogance, or self-delusion on the part of executive decision-makers. But, in large measure, the changed role of the American corporation and the resulting transformation of the nation's workplaces and labor markets can be ascribed to broad economic and social forces external to any single firm and beyond the power of any corporate executive to change.

The Forces for Change: Slowdown, Volatility, and Sharpened Competition

Change was forced on these enterprises by the combination of a global slowdown in growth, increased economic volatility, and enhanced competition. These pressures reached galloping force in the 1970s and 1980s and have persisted, in somewhat different forms, in the 1990s. The global economy was severely buffeted by the 1973 demise of the Bretton Woods system of exchange rate management and the resulting sharp increase in the volatility of exchange rates. The ensuing oil shocks of 1973 and 1979 dramatically disrupted patterns of economic activity in industrial nations and caused severe debt problems in developing countries. Growth slowed in virtually every industrial nation, and inflation and unemployment worsened.

In a much more volatile and uncertain economic environment, more gradual but equally significant structural developments were
increasing pressures on all participants in the corporate enterprise. Three forces in particular underlay these pressures: global economic integration, domestic deregulation, and the advance of information and communications technology. Together, these developments intensified competition and squeezed the slack out of virtually every market in which corporations operate.

The impact of these three forces, and the interactions between them, was felt first and foremost in the form of intensified competition in product markets. The steady decade-by-decade erosion of nonfinancial corporations’ pretax profit margins, from 16.9 percent in the 1950s to 10.9 percent in the 1990s (through 1997), is one manifestation of the sharp change from the 1950s and 1960s, when “most leading U.S. industrials held their dominant position in domestic markets without substantial price competition.” Reduced market power is also reflected in a decline in concentration ratios, which measure the degree to which a small number of firms dominate a market. A study based on this criterion found that the share of national income generated in “effectively competitive” markets rose from 56 percent in 1958 to 77 percent in 1990.5

In the minds of most Americans, foreign competition heads the list of explanations for sharp increases in competitive pressures. In a 1993 survey of 132 large manufacturing firms, for example, three quarters of the executives who replied agreed strongly that “my firm faces much stiffer competition than it did just 10 years ago,” and more than 70 percent affirmed that they are in competition with foreign as well as domestic firms. One executive summed up the driving forces behind the organizational changes in American manufacturing in a monosyllabic response: “Toyotas.” For many Americans, that one word symbolizes the end of an era of comfortable supremacy for leading American corporations, a demise marked by erosion of market shares, loss of customer loyalty, and a dramatic increase in the number and variety of competitors and in the intensity of competition for the customer’s dollar.

Although the United States remains far less dependent on trade than most other countries, the importance of trade in the U.S. economy has increased significantly, rising from less than 5 percent in 1960 to 17 percent in 1994. More striking is that merchandise exports as a share of “tradable goods” production rose from 11 percent in 1960 to more than 31 percent in 1990.
The impact of these aggregate numbers shows up on the import side, in the way U.S. firms in industries where they once dominated in world market—including steel, automobiles, consumer electronics, and machine tools—have either transformed themselves or wasted away as upstart foreign newcomers challenged them on their home turf. On the other side of the ledger, exports command an increasing share of the sales of American firms. While this is testimony to the competitiveness of these firms in global markets, it also signals their growing exposure and vulnerability to competitive pressures around the world.

At the same time, the convergence of the European and Japanese economies toward U.S. levels of income, productivity, and technological advancement, together with a steady reduction in barriers to international trade and investment, and rapid advances in information and communications technology, have led virtually all large firms in the leading industrial countries to become multinational in scope. As a result, foreign direct investment (FDI)—investment involving active control of a firm’s decision-making—has increased even more rapidly than trade. This means that American firms are increasingly likely to encounter new competition not only from imports but also from U.S.-based subsidiaries of firms headquartered abroad—what are called “transplants” in the automobile industry.

Likewise, American firms compete globally not only via exports but also by establishing operations in other countries. By the mid-1990s, in fact, the annual sales of foreign affiliates of multinational corporations exceeded the more than $6 trillion annual total of world trade in goods and services. FDI multiplies the channels of competition in markets for tradable goods and extends such competition to services like banking, advertising, and insurance, which generally require local investment to interact effectively with customers. This extension of global competition from industrial sectors to services continuously shrinks the range of economic activities that can count on a domestic market protected from foreign competition. At the same time, American firms are confronted at home and abroad by competition from a growing number of economic actors, as many countries at various levels of income and economic development that were formerly isolated from the world of market commerce have now entered it.

Globalization has made the deepest impression on our collective consciousness, but competitive pressures have been reinforced by
domestic policies, particularly by economic deregulation. Industries such as airlines, railroads, trucking, and telephone service—all closely regulated in the 1950s and 1960s regarding the kinds of services they could provide, the areas in which they could operate, and the prices they could charge—were progressively opened up to market competition in the 1970s and 1980s. The electric power industry appears to be undergoing a similar process in the 1990s. And in financial services, progressive deregulation has vastly enlarged the scope for competition both within and between industries, as the lines between banking, securities, and insurance become increasingly blurred.

Advances in information and telecommunications technology have also promoted competition by eroding formerly sharp distinctions between products and services and by multiplying the channels—from stores to catalogs to the internet—through which consumers can access them. Cyberspace magazines like Slate, for example, now compete with traditional print publications for the reader’s attention and the advertiser’s dollar. The march of technology is even beginning to blur the boundaries between home computers and television sets, spurring competition to develop innovations that can combine the characteristics of what were previously distinct products in new, consumer-friendly ways.

Perhaps the most dramatic increase in competitive pressures has arisen from synergistic interactions among globalization, regulatory liberalization, and technological advances. Technological progress, in particular, has placed financial services, telecommunications, and transportation at the leading edge of the globalization process, positioning them as “the new infrastructure for trade—all highly integrated on a global basis, with greatly reduced costs...the great facilitators of international trade and investment.” At the same time, globalization has stimulated the pace of technological advance by intensifying competitive pressures and speeding up the international diffusion of technology.

The most direct link between globalization and changes in the regulatory environment is through trade liberalization. The high tariffs and restrictive quotas that proliferated during the Great Depression of the 1930s still walled off national markets in the 1950s. By the end of the most recent round of multilateral tariff negotiations under the auspices of the General Agreement on Tariffs and Trade (GATT), average tariffs had been reduced to a fraction of
their former levels, some important ones had been eliminated entirely, and many restrictive quotas and other nontariff barriers had been wiped off the books. Trade-liberalizing regional arrangements like the European Union (EU) and the North American Free Trade Agreement (NAFTA) have also contributed to growing cross-border competition, as have the unilateral steps taken by many developing and formerly communist countries to open up access to their markets and expose their previously heavily protected industries to international trade and investment.

The impact of domestic deregulation on global competition is more subtle. The antitrust actions that forced IBM to modify its vertically integrated structure, with the aim of stimulating domestic competition, also had the unanticipated effect of opening up new opportunities for foreign manufacturers of microchips and semiconductors. And, although the United States has led the way in domestic deregulation, a number of other industrial nations have begun to follow suit. Even Japan, whose pervasive network of domestic regulations has been the source of both trade frictions and bilateral negotiations with the United States, has begun, slowly and often in the face of strong political opposition, to loosen up. Most dramatic of all is the market-oriented reform on the part of many developing nations and formerly communist countries, involving not only trade-liberalization but also complementary steps toward domestic deregulation and privatization. All of these developments interact to promote market access and competition on an international scale.

The bottom-line result of growth in product-market competition is a sharp increase in the choices available to customers and a dramatic shift in power from producers to consumers. In industry after industry, producers who used to tell their customers what to buy or how service would be provided are now going to great lengths (and expense) to discern and respond to customers’ demands. This shift in power and the resulting competitive pressures exceed what is indicated by the statistics on reductions in concentration and the growth of trade and investment. This is because the shift is based not only on actual increases in competition but, more fundamentally, also on an increase in the quantity and quality of information available to customers and the speed with which they can access it. The result is a sort of “virtual” competition in which no actual change in the flow of transactions need occur. A producer’s
knowledge that his customers have access to information about the alternatives available on a global basis is sufficient to turn up the competitive heat.

Who Is In Control? From Managerial to Investor Capitalism
While the managerial discretion enjoyed by executives of large American corporations in the quarter century following World War II has been increasingly limited by intensified competition in product markets, it has also felt growing pressure in financial markets and the development of a turbulent market for corporate control. These changes have rendered capital less patient and investors less passive than before, forcing management to devote more focused attention to profitability and returns to shareholders.

Increased competitive pressures in financial markets have arisen from some of the same developments that have affected product markets. Indeed, the globalization of capital markets has been even more striking than that of product markets. While world trade has increased roughly twice as fast as world output over the second half of the twentieth century, FDI grew four times as fast. Beginning with the advent of the Eurodollar market in the 1970s, it has become increasingly possible for corporations located in one country to borrow, in a second country, funds denominated in the currency of a third. Today, both lending and equity markets are linked globally, although integration is much farther advanced in the former than in the latter. European and Japanese banks are competing in the U.S. market, either by setting up subsidiaries or branches or by buying up existing American banks, while large U.S. banks are building up their operations in other countries' financial markets. Developments within the United States have also contributed substantially to financial competition. During the 1950s, 1960s, and into the 1970s, the major business of banks was taking deposits, making loans, and earning profits on the "spread" in interest rates between the debit and the credit sides of the ledger.

Because direct lending by banks of funds received from depositors was the major source of debt finance, geographical fragmentation tended to create local monopolies or quasi-monopolies in lending. State and federal regulations prohibited banking across state lines; interstate bank holding companies were legalized only in the late 1980s, and extending bank branches across state lines did not become legal until 1996. A few of the largest banks lent on a
national or even an international basis, but most confined the bulk of their lending within their home states or localities, and even the largest ones displayed considerable home-area bias. On the borrowing side, the number of corporations able to borrow money nationally or internationally was comparably limited. Today, the reach of the largest banks is not merely nationwide but global, and the number of companies able to tap world markets for funding has vastly increased.

Deregulation has allowed U.S. financial institutions to spread out functionally as well as geographically. The regulations that once confined commercial banks, securities firms, and insurance companies strictly within their separate spheres of operation have been significantly loosened. Insurance companies are selling variable annuities whose primary purpose is not insurance but investment, and commercial banks are increasingly getting into the business of investment banking. Although efforts have stalled to amend the 1930s-era Glass-Steagall Act, which erected a wall between commercial and investment banking, a 1996 change in federal regulations gave commercial banks substantially increased leeway to hold and deal in equity securities.

As deregulation permits American banks to spread out both geographically and functionally, the highly fragmented U.S. banking scene is undergoing substantial consolidation. Virtually every month, the financial pages report a merger or friendly takeover involving two banking giants. Overall, the number of banking institutions in the United States has declined by 36 percent since 1984. Consolidation may reduce local competition in some places, but nationally and globally it almost certainly increases it by creating supra-regional powerhouses able to compete with money-center banks in New York, Chicago, and San Francisco that previously had major banking markets largely to themselves.

Perhaps most consequential of all in its impact on financial markets is the changing nature of what banks do. They are functioning less and less as direct lenders, earning a growing proportion of their income from fees on transactions and from trading in markets for foreign exchange and for debt instruments of varying types and maturities. Such trading involves increasingly innovative and sophisticated “derivative” financial instruments whose existence was made possible by the advent of powerful computers. An increasing proportion of loans originated by banks are being “laid
off" rather than being held on their own books. Mortgages, auto
loans, and credit-card debt are securitized, packaged and sold off
into secondary markets, and banks and other financial institutions
also earn substantial fees from underwritings, only a small proportion
retained for their own accounts.

One result of all these developments is a depersonalization of
lending, as local institutions that once relied heavily on interpersonal
relationships give way to distant and impersonal sources of finance.
These changes increase competitive pressures on users as well as
providers of funds by eroding the sources of "patient capital" once
provided by banks that usually knew their borrowers personally.
Those banks now have to confront the constant possibility that
their depositors will desert them for a fractional increase in the
interest rate on deposits or that their shareholders will permit or
even pressure them to disappear in a merger or takeover if their
profits fail to keep pace with those of their peers.

The managerial discretion enjoyed by executives of large
corporations in the golden age of managerial capitalism was due in
part to the far less intensive competition these organizations faced,
both as sellers of goods and services and as borrowers of funds. But
probably the most decisive factor in the wide latitude they enjoyed
to pursue goals other than profit maximization was the passivity of
their shareholders. The basis for this passivity, the almost total
separation of ownership from control that had been noted as the
hallmark of American capitalism as long ago as the 1930s, persisted
and increased during the decades immediately following World
War II. By 1975, an estimated 80 percent to 85 percent of the
country's 200 largest nonfinancial corporations were controlled by
management instead of by a significant shareholder or creditor.
Under these circumstances, stockholders dissatisfied with their
company's performance had no alternative but to sell their shares.

This situation stands in marked contrast to the ongoing state of
affairs in Germany and most other continental European nations as
well as in Japan. Banks in these nations are far fewer and more
consolidated than in the United States, which has almost 39 banking
institutions per million residents, as compared with 4 per million in
France, 2 in Germany and the United Kingdom, and 1 in Japan. And
in these countries, banks remain the major source of borrowed
funds for nonfinancial corporations; in France, Germany, and Italy
some 70 percent of corporate financing comes from banks, as contrasted with only 25 percent in the United States. In addition, banks in these countries, which have no legislation comparable to America's Glass-Steagall Act, either control or own outright substantial fractions of the shares of their nations' largest nonfinancial corporations. Thus, as both major creditors and major shareholders, financial institutions play a far larger role in corporate governance in most other industrial nations than they do in the United States.

Around the middle of the 1970s, the trend in the United States toward increasing separation of ownership from control began to reverse itself. For the thousand largest firms in terms of market value, the share of publicly held stock owned by pension funds, mutual funds and other large institutional investors rose from 16 percent in 1965 to 57 percent in 1994. As their ownership of corporate America grew, institutional investors exercised their new power in a variety of ways. In particular, they played a major role in the development of the market for corporate control that emerged in response to the profit erosion and resulting collapse of stock prices in the 1970s.

Frustrated by these developments and empowered by economic deregulation and a more relaxed antitrust environment, financial innovators sought new ways of wringing improved financial performance from companies that had grown complacent and unfocused. The result was an unprecedented wave of mergers, breakups, hostile takeovers, and leveraged buyouts in the 1980s. In their efforts to enhance investor returns and portfolio values, institutional investors used their funds, their shares, and their shareholder votes to facilitate such transactions. Mergers and acquisitions of publicly traded companies more than doubled between 1980 and 1988, and leveraged buyouts rose by a factor of 10. Executives of companies with disappointing earnings or sagging stock prices, and even of companies that were doing well, felt their positions threatened along with the very survival of their firms.

Along with the threat of possible takeover or buyout, the massive amounts of debt that generally resulted not only from corporate restructurings but also from firms' efforts to erect defenses against hostile takeover, made corporate executives focus with new intensity on profits and returns to shareholders. When the merger and acquisitions frenzy abated sharply, if temporarily, at the end of the 1980s, institutional investors adopted new mechanisms for
expressing their views on the management of the corporations
whose shares they hold. When merger and acquisition activity
resumed with a vengeance in the 1990s—nearly tripling in number
and increasing almost tenfold to more than $1.5 trillion in dollar
value between 1992 and 1998—these mechanisms were nonetheless
expanded and refined.

Empowered by favorable changes in the rulings of the Securities
and Exchange Commission in 1992, institutional investors have
pressured corporate managements to negotiate with them on matters
of corporate governance to keep such resolutions off the ballot in
annual shareholder votes. Where such negotiations were either
refused or unsuccessful, such investors have brought the pressure
of publicity to bear by putting such resolutions on the ballot,
although they have rarely garnered enough votes to force a change.
Some institutional investors, public pension funds in particular,
have also utilized other forms of publicity to bring pressure on
boards of directors, and through them on chief executives, whose
performance they do not regard as satisfactory. All these
developments, taken together, are forging new links between
ownership and control, whose sharp separation had earlier created
broad discretion for the managers of publicly held corporations to
set their own goals and priorities.

Nowhere is the link between ownership and control more
significant, nor the uniqueness of the U.S. capital-market infrastructure
more pronounced, than in the availability of venture capital for
new start-up firms, particularly in industries on the technological
forefront. There are a number of reasons for the accessibility of
funds to such fledglings, including: Americans' high regard for
innovation and entrepreneurship; the explosive growth of mutual
funds, with their emphasis on high returns; the social acceptability
of bankruptcy; and changes in capital gains taxation and the regulation
of pension fund management in 1978 that favored the growth of
such a venture-capital pool. In Germany and Japan, in contrast,
both social attitudes and the legal-regulatory structures, as well as
the dominance of banks as both lenders and investors, all combine
to give large, long-established firms preferential access to capital
and to limit sharply the access of new, small, untried enterprises.

The close integration of ownership and control in the American
venture capital world arises from the deep involvement of the
providers of such funds in the governance of the enterprises they
finance, since they generally insist on a majority, or at least controlling,
stake in the new firm. The original entrepreneurs, in other words, give up control of their infant undertaking in return for access to essential funds in the form of capital that does not have to be repaid, and often is not, since high risk accompanies high returns in the venture-capital industry.

The result is the continual birth and death of firms in a Darwinian competition for the survival of the fittest. The average age of the firms listed on the New York Stock Exchange is 14 years, as contrasted with 55 years for firms on the pan-German exchanges. And the shares of less-than-10-year-old companies listed on the stock exchange is about 40 percent, compared to less than 1 percent in Japan. Taking a slightly different perspective, Italy’s prime minister has noted that “of the 25 biggest firms in the USA at present, 39 did not exist or were virtually negligible before 1960... while none of the 25 major European firms are new, all having been on the scene for over 30 years.”

Increased competition in any of the markets discussed so far would curtail the freedom of corporate executives to pursue goals other than profit maximization. Taken together, changes in product markets, financial markets, and the market for corporate control reinforce each other and thus magnify such effects. Product market competition “helps to expose managerial waste and increases the chance that inefficiency will translate into financial failure.” And competition in the other two markets raises the odds that a decline in financial performance, or even failure to perform up to analysts’ expectations, will have serious consequences for senior management. The combination constrains executives to focus more intently than before on the bottom line.

Capital Flows and Corporate Governance
The combination of increased competition in product markets and intensified competition for globally mobile capital is exerting pressures for convergence among the different styles of capitalism that determine the interaction between corporations and their investors and creditors, forcing firms everywhere to pay more attention to good governance, efficiency, and profitability. At present, profitability differentials are substantial: the net return on equity for firms listed on the leading exchanges are estimated at 27 percent in the United States, 14.5 percent in continental Europe, and 3.5 percent in Japan.
The internationalization of capital flows in recent years has been dramatic. Cross-border transactions in bonds and equities, which equaled some 4 percent of U.S. gross domestic product (GDP) in 1975, had ballooned to more than 150 percent of GDP in 1996. The equivalent share for Germany are 5 percent in 1975 and nearly 200 percent in 1996, and for Japan 1.5 percent and more than 80 percent; similar trends are apparent in other leading industrial countries as well. The severe financial crises of 1997-98 in Korea and several Southeast Asian nations are a particularly dramatic object lesson on the potentially explosive collision between internationally mobile capital and domestic "crony capitalism." Some of the strongest leverage for improved governance practices abroad comes from American institutional investors, some of whom are exporting their techniques of shareholder activism as they expand their holdings of non-U.S. equities. The U.S. government reinforced the drive toward cross-border shareholder pressure in 1994, when the Labor Department began to require pension managers to "examine foreign proxies and cast informed votes with the same diligence as in the United States." And in 1998, the largest public pension fund in the United States and Great Britain's biggest pension-fund manager, who together controlled nearly $100 billion in equities, joined forces in a trans-Atlantic alliance. Its purpose is to pressure underperforming companies to improve their governance practices.

Changing legal and regulatory requirements in Europe, Japan, and the United States are also contributing to the long-term convergence of corporate governance practices in the three regions. In Germany—where the combination of recession and new investment needs and opportunities in eastern Germany created an urgent need to look abroad for new capital—legislative and regulatory moves to tighten accounting standards, criminalize insider dealing, dismantle restrictive voting structures, and legitimize takeovers are weakening the influence of boards and increasing the power of institutional shareholders.

The European Commission is putting pressure on Germany and other member countries to facilitate takeovers and, more generally, to dismantle legal and regulatory obstacles to the development of corporate-securities markets. Privatization of formerly state-owned firms in Germany, France, and other European nations is also expanding market-based controls that force management
and boards to focus on shareholder returns. Above all, the advent of the European common currency, the euro, on January 1, 1999, is expected to spur further bank consolidation, intensified competition among European capital markets. The merger and acquisitions boom that has been underway in Europe since 1994, with such deals as British Petroleum's $46 billion buyout of Amoco and France's Société Générale's $35 billion acquisition of Union Bank of Switzerland, will probably continue, with American companies expected to be active participants.

These developments have all served to weaken traditional market discipline among Northern European businesses, which have long been subject to the checks and balances of the Bank of England and the Bundesbank. The European Parliament is expected to pass a new capital markets law in 1999, which may further deregulate the eurozone's capital markets.

In Japan, the aging population is increasing pension funds' needs for cash flow and stimulating them, in turn, to exert shareholder pressure. The result is increased transparency of financial information, strengthened control of board members, and an active search for increased dividends, tightened audit requirements, and greater transparency of financial information, according to the Foreign Investors' Federation of Japan. The result is an emerging market for corporate control, with such players as the Northwest Office of the Ministry of Finance, the Japan Securities Dealers Association, and the Tokyo Stock Exchange.

All these developments, taken together, operate to strengthen the market-based capital markets, which, in turn, help to make Japan a more competitive country. The result is increased transparency of financial information, strengthened control of board members, and an active search for increased dividends, tightened audit requirements, and greater transparency of financial information, according to the Foreign Investors' Federation of Japan. The result is an emerging market for corporate control, with such players as the Northwest Office of the Ministry of Finance, the Japan Securities Dealers Association, and the Tokyo Stock Exchange.

The growing role of the market is also evident in the United States, where activist institutional shareholders are playing an increasingly active role in corporate governance. This is evidenced by the recent purchases of blocks of stock by both the Northwest Office of the Ministry of Finance, the Japan Securities Dealers Association, and the Tokyo Stock Exchange.
pressures are forcing managers and boards of directors everywhere
to focus more intensively than ever before on maximizing wealth
creation and satisfying securities markets.

Loosened Bonds: Companies and Their Employees

The three underlying forces—globalization, technological advance,
and government policies of trade liberalization and economic
deregulation—which have intensified competition in all the markets
discussed so far, are also having a major impact on the nature of the
American labor market. Indeed, no other single change in the role
of the corporation has had a more dramatic impact than the changing
social contract between a company and its employees at all levels.
The old social contract, as most Americans understood it, had four
major characteristics: permanence in the employer-employee
relationship; entitlement, not only to a job but also to steady pay
advancement and generous benefits; paternalism, in the form of a
shared view of employees as part of a company “family”; and
hierarchy, such that lines of authority and levels of status were
clearly defined within the firm and carried over into the outside
world.

The implicit contract between employers and employees is
very different today. Employment relationships, once assumed to
embody a reciprocal lifetime commitment, are more likely to be
regarded today as contingent and probably temporary. A job,
benefits, and pay advancement are no longer regarded as automatic
entitlements. Instead, the emphasis is on performance and on
individual responsibility for one’s own future in the workplace.
Today, employees may be seen as costs to be minimized or as
highly valued assets, but both images reflect a factor of production
instead of status as a family member. Few employees today see
their employer as a parent figure; most would find such a relationship
patronizing and distasteful. It would also be inconsistent with
current concepts of effective management, which have replaced the
hierarchical, authoritarian model with a more networked and
participatory management style.

The loss of job security began at the very top, when the
“boardroom revolution,” precipitated by the pressure exerted on
boards of directors by dissatisfied institutional shareholders, led to
the abrupt departure in 1992–93 of the chief executives of such
venerable firms as American Express, General Motors, IBM, Sears,
and Westinghouse. The chief executives of other large, well-known
firms met with similar fates, or lost their positions to mergers or takeovers, in the years that followed.

But no level or type of job was exempt. Corporate layoffs and downsizings that affected middle managers, line workers, and support staffs alike reached unprecedented levels in 1992-93, even though the American economy was expanding, and the overall unemployment rate was falling. Job-loss rates reached their highest level in 15 years, having been on an increasing trend for several decades, as had the proportion of permanent, as opposed to temporary, layoffs. Additionally, the heightened risk of job loss spread to categories that previously had been relatively immune, including older, more educated, and white-collar workers. In light of these developments, it is hardly surprising that many surveys indicate a long-term decline in employees’ sense of job security.

The most striking manifestation of increased flexibility and impermanence in the employment relationship is the expanding use of a “peripheral” or “contingent” workforce, consisting of temporary, self-employed, and part-time workers and contract business services. Although the proportion of the U.S. workforce accounted for by part-time and self-employed workers has remained relatively stable since 1972, the share accounted for by temporary employees and business services increased more than six-fold between 1972 and 1995, though from a very small base. This type of employment has been the fastest growing source of new jobs in the 1990s. In the past, such employment was associated almost entirely with low-paid occupations requiring little in the way of specialized skills. But today, the fastest growing subcategory of such workers is professional-technical, including doctors, lawyers, engineers, accountants, and even business executives employed “as-needed.”

Even for long-term employees with large-firm employers, the assumption of automatic entitlement to steadily advancing pay and generous benefits is also changing. Employees of large firms have traditionally been paid more than their counterparts at smaller firms, and this wage premium tended to rise with seniority. Today, these patterns are under pressure, as companies experiment with more flexible pay plans, including various forms of profit sharing.

This tendency is most pronounced at the top: the pay of senior executives is increasingly variable, dependent in some way either on individual performance, in the case of bonuses, or on the financial performance of the firm, in the case of stock or stock options, or both. In 1992, two fifths of the chief executive’s total compensation, on average, was variable; by 1995, the average proportion had risen
to 70 percent. And it is the variable portions, particularly restricted stock and stock options, that have accounted for the lion’s share of the very large increases in the pay of top executives during the 1980s and, even more, during the 1990s.

Compensation has also become more variable throughout the workforce. During the 1980s, the proportion of all wage and salary workers whose pay included a variable or contingent component (such as lump-sum payments, bonuses, or some type of profit-sharing) increased substantially. These trends appear to have persisted into the 1990s. A survey by a leading consulting firm found that in 1996 about 61 percent of large and medium-sized companies offered some kind of variable pay, up from 47 percent in 1990.17 Even fixed wages and salaries are increasingly likely to vary with individual performance evaluations. A 1994 survey of 317 large companies found that 90 percent used some form of “pay for performance.” 18 Fringe benefits as a share of total compensation, which had long been increasing steadily, leveled off after 1979. The proportion of full-time workers covered by such plans also decreased, from 60 percent in 1979 to 55 percent in 1988 in the case of pensions and from 74 percent to 72 percent in the case of health coverage. In both cases, the lowest-paid experienced the sharpest drop-off in coverage; the highest-paid, the least.19

Union Contracts and Union Coverage

In settings where the implicit company-employee contract has been formalized and made explicit in union contracts, all these developments are cast into sharp relief. A leading labor economist reports:

a striking transformation in union contracts starting in the early 1980s, a transformation that is not well accounted for either by the disinflation of those years or the above-average unemployment rate. The transformation was reflected in wage freezes and cuts, which first showed up in a narrow range of industries in 1981 and then spread to others.

Management appeared to be taking an increasingly harder stance.19

This shift was also manifested on the other side of the bargaining table. Between the mid-1970s and the early 1980s, unions focused primarily on earnings. In every year between 1976 (when data first became available) and 1982, union wage hikes outpaced nonunion
wage increases. In the latter half of the 1980s, in contrast, union wages grew significantly less than did nonunion pay, suggesting that "many unions placed job security above wage growth as the top priority in their bargaining rounds." 31

Evidence of such a "norm shift" in wage determination appears in industry after industry. Some, like metal manufacturing, lumber and paper, and aerospace, experienced increased exposure to international trade in the early 1980s. In others, domestic deregulation was decisive. When trucking was deregulated at the end of the 1970s, the International Brotherhood of Teamsters rather than the trucking companies apparently bore the primary brunt of lost monopoly rents. In still other industries, like retailing, new competitive pressures generated by advances in information technology appear to have predominated.

Even more fundamental than changing bargaining patterns in unionized industries is the shrinking role of unionization itself:

In 1955 approximately one-third of the American labor force and a majority of the hourly workers employed by large corporations were covered by collective bargaining agreements. By 1995 only 16 percent of the overall labor force and less than 11 percent of the private sector labor force were organized. 32

Unions continued to hold their own only in the public sector where, at least until the recent intensification of pressures for privatization of government services, workers were protected from the forces of competition. This rapid decline in unionization has profoundly undermined the main source of pressure for stability and uniformity in the relationship between companies and workers. It is both a symbol and a result of increased economic pressure to increase flexibility and variability in relationships between employers and employees.

From Paternalism to Partnership

The paternalism that was the hallmark of traditional large firms tended to erode the autonomy of both workers and executives. For workers, both blue-collar and clerical, mass production methods and the associated division of work into highly specialized, standardized, repetitive tasks eliminated the need, or indeed the opportunity, to think for themselves and take responsibility for the quality and effectiveness of the overall process.
Today, the availability of information technology, increased pressure to get the most out of every employee, and lessons learned from the success of Japanese methods of organizing production and managing workers are leading to major changes in firms’ organizational structure. For companies at the forefront of these developments, this has meant a shift from traditional hierarchies with well-defined boundaries between functions toward more decentralized decision-making and downward delegation of responsibility. These changes include compression of management levels, increased flexibility in job descriptions, and greater use of teams.

Managers are having to make the transition from a command- and-control style of management to a coaching-teamwork style. Meanwhile, workers are being asked to concentrate on satisfying customers and to think in terms of the “big picture” of their enterprise. By 1992, programs instituting employee participation in decision-making had been adopted by more than 80 percent of American firms and diffused to perhaps one third of the nonmanagerial workforce. The use of cross-functional teams with broadened decision-making powers has also expanded to cover nearly 40 percent of all workplaces today.

Expecting more of employees would be meaningless unless they are given both the necessary tools and the broadened scope for decision-making required to “empower” workers and create “high-performance” workplaces. The specific techniques used to create such autonomy and professionalization of work are many and varied, but they all have at least two features in common. One is providing throughout the organization far more specific, objective data than ever before and, if necessary, giving people the training required to understand it.

The second critical feature in this new social contract is much stricter accountability, both upward and downward. Among the means companies use to institutionalize such accountability are mission statements, a clearly articulated set of company principles, clear and jointly drafted job descriptions, and regular performance evaluations at every level, from the chief executive on down. One interesting development in this last category is the “360-degree evaluation,” which includes input from managers’ peers and subordinates as well as their immediate superiors.

This description of the ways in which worker autonomy is enhanced under the new social contract is, of course, an ideal that
is by no means universally achieved. Scott Adams’s Dilbert, the
hilarious cartoon chronicle of the multiple ways in which bosses
fold, spindle, and mutilate long-suffering employees, would not
have hit best-seller lists if its caricatures of the modern workplace
did not resonate with the experiences of many Americans. The
message of Adams’s popularity is that many companies have adopted
the vocabulary but not the reality of increased autonomy and
power sharing.

If the relationship between employers and employees varies
from firm to firm far more than it used to, employees themselves
are a far more diverse and inclusive group than in the past. Women
and minorities both increased substantially as shares of the workforce
between 1975 and 1995 and are forecast to increase further by 2005.
Both groups hold a much wider range of jobs than before and have
steadily increased their participation in the better paid occupational
categories: as managerial, technical and professional workers in the
white-collar categories and as skilled workers in the blue-collar
categories. Beyond this increase in the participation of women and
minorities, the diversity of the modern workplace encompasses
reductions of required conformity in many dimensions. Greater
diversity in workplace dress is merely a symbol of the acceptance
of a far greater variety in personal characteristics and lifestyles
than would have been tolerated at mid-century.

The new social contract between firms and workers contains
an inherent tension between the temporary or contingent nature of
their relationship and the degree of commitment required by the
high-performance workplace. Corporations use many methods to
reconcile the need for flexibility and adaptability with the need for
mutual trust and commitment. One such measure is compensation.
Not only are the employees of large firms generally paid more than
they could immediately earn elsewhere, but more and more publicly
held companies are also giving an increasing number of their
employees a contingent piece of the action. They do so by extending
farther down through the ranks performance-related bonuses, profit
sharing, or even stock or stock options, forms of compensation
previously confined almost exclusively to executives. A 1996 survey
of 350 large firms found that some 30 percent of them had broad-
based stock-option plans, up from 17 percent in 1992.25

But compensation is by no means the whole story. As old-style
loyalty wanes, a new style is growing, a “professionalization” of
commitment that is giving rise to a new kind of loyalty, not to the
company but to a “community of purpose: a shared commitment to
the accomplishment of a mission, without a permanent and dependent relationship of employee to employer. Such a community of purpose has become the hallmark of the high-tech firms in Silicon Valley, for example, where managers and workers alike are noted both for their willingness to work inhuman hours and their constant job-hopping in search of new challenges as well as higher pay.

In more traditional industries, forward-looking employers are seeking to develop and codify a contract with employees, built on shared goals, mutual interests, performance, and opportunities for challenge and personal development. Waning expectations of long-term job security with a single firm have given rise to the concept of “employability security,” in the form of measures that increase a person’s probability of making a successful job transition. Some companies have begun to include an explicit commitment to enhancing employability in their written “social contracts” with workers.

In some highly unionized industries that experienced prolonged downsizing during the 1980s and early 1990s, for instance, automobiles and telecommunications, such commitments took the form of company-financed training programs established under collective-bargaining agreements and jointly led by management and unions. When plant closings, layoffs, and forced early retirements rose again in 1998, the importance of a successful job transition appeared to be uppermost in the minds of both executives and workers: “Rather than protest, unions are more likely to help laid-off members make the transition to other jobs, often working in tandem with the very managers who did the laying off. For their part, corporate executives...fatten severance packages and announce layoffs well in advance of the final day.”

Education and training are a prime requirement of both the high-performance workplace, with its emphasis on increased autonomy and responsibility for workers, and the concept of employability security. Indeed, the 1980s did see a substantial increase in firm-sponsored training programs:

Between 1983 and 1991, while the workforce expanded by 19 percent, the number of workers reporting that they had taken training to improve their job skills rose by 39 percent. The number of employees who had received formal company training more than doubled, rising from 7.3 million to 18.0 million.

Employee investment in their own education has also increased: “In 1970 more than one in three workers had completed less than four years of high school; by 1990 only one in eight was so limited.”
In 1970, one in four workers had at least some college; by 1990 it was nearly one in two.\textsuperscript{27}

Although success rates vary widely, investment in training appears on the whole to have paid off for employers. One analysis revealed, for instance, "that companies that had introduced formal training programs in the early 1980s had achieved productivity gains 19 percent greater within three years than firms that had not."\textsuperscript{28} Still, an underlying conflict of interest persists between employers and employees regarding the nature of training. Employees want general training that enhances their value to other firms as well as to their present employer, whereas company training programs "generally enhanced employee skills for the firms in which they are obtained but offered relatively little in the way of transferable skills."\textsuperscript{29} Despite increased investment in training by American employers, the United States still has a long way to go in comparison with other industrial nations. An estimated 8 percent of new employees in the United States received formal company training in 1991; comparable percentages were around 20 percent for European countries and 79 percent for Japan.\textsuperscript{30}

The Changing Contract and the American Economy: Benefits

These changes in the implicit workplace contract between employers and employees have had a mixed bag of effects, both positive and negative, not only on individuals in the workplace, as described above, but on American society at large. The old contract was built on security, predictability, and mutual commitment, but its other face was rigidity and inertia. As managerial complacency was swept away, American industry shaped up. Manufacturing, which had seen its competitiveness slip during the 1970s to the point where it was regarded at home and abroad as "the gang that couldn't shoot straight," is once again meeting, and often setting, global standards for performance. Newly focused, downsized, and de layered American firms are once again producing goods that are both high quality and cost-competitive.

The processes of downsizing and restructuring that disrupted the old social contract also made possible essential cost-cutting and improvements in efficiency. The fact that unit labor costs rose more slowly and manufacturing productivity rose more rapidly in the United States than in other leading industrial nations during most
of the 1990s played a central role in the restoration of American competitiveness in the global economy. Today, the United States holds the number-one spot in rankings of global competitiveness and is once again the world’s leading exporter.

These developments do not merely put us at the head of the class on some abstract global report card. Our low level of unemployment and robust pace of job creation are the envy of other industrial nations. The real growth of the economy, though still below expectations and below the precedent-setting levels of the immediate postwar decades, compares very favorably with that of other leading industrial countries. The American economy has experienced gradual but steady expansion through most of the 1990s, while the economies of the two economic superpowers of preceding decades, Germany and Japan, seem mired in difficulties.

The increased flexibility in workers’ pay contributed decisively to the favorable shift in the inflation-unemployment relationship of the latter half of the 1980s that has persisted ever since. This shift has allowed the United States to enjoy a combination of low inflation and low unemployment that is favorable not only in comparison with our own recent history but also with the experience of virtually every other major industrial country. Early in 1997, as the American expansion of the 1990s approached a postwar record for durability, Fed Chairman Alan Greenspan made explicit the role of the changing social contract in prolonging that expansion. In his view, workers’ job insecurity and the resulting “atypical restraint on compensation increases,” more than any other factor, prevented wages from accelerating, despite increasingly tight labor markets, thus averting the need for the Fed to raise interest rates and thereby risk choking off the expansion.31

The advantages of increased market discipline, expressed at the macroeconomic level in reduced inflationary pressures, are paralleled at the microeconomic level by lower prices, wider choice, and better quality. Oligopolistic firms tend to incur higher costs as well as higher accounting profits and to charge higher prices to consumers than would prevail in a more competitive environment. One need only compare airfares in the fiercely competitive U.S. airline industry with those of its regulated oligopoly European and Japanese counterparts to see that, despite all the complaints, the competition bred by deregulation has had a democratizing effect on American air travel. Similarly, lively competition in the U.S. computer industry, combined with rapid technological advance,
has produced an astonishingly rapid decline in prices and an exponential increase in the power of its products.

Competition from abroad has multiplied the power of the consumer. Automobile buyers, once largely confined to choosing from among the offerings of the Big Three, now find some 17 manufacturers vying for their business, and the choice and range of models has proliferated accordingly. The same story can be told about many other consumer goods, including toys, clothing, and consumer electronics, all categories characterized by strong global competition, in which prices rose by less than the overall average over the decade 1985-95. And this intensified competition for the customer’s favor is not confined to product characteristics alone. Companies are also employing advanced technology to tailor product and service combinations to meet the needs of different groups of customers.

In the long run, Americans benefit as both producers and consumers from U.S. firms’ reassertion of the technological lead in multiple spheres. Two studies by the McKinsey Global Institute, one focused on manufacturing and the other on services, found systematic evidence that the United States has the world’s highest productivity in both broad areas of economic activity. Both everyday observation and more systematic economic analysis tell us, however, that American firms would not have regained their competitive edge without the stimulus of increased competition, including but by no means limited to foreign competition. The decline in American manufacturing chronicled in Made in America; the study by the MIT Commission on Industrial Productivity, would not have been reversed if American manufacturers had not learned from Japan’s system of “lean production” and its revolutionary reorganization of the relationships between design and process, between people and machines, and between manufacturers and suppliers.

More systematic studies bear out these observations about the capacity of competition in general, and global competition in particular, to stimulate the pace of improvements in efficiency and quality. The McKinsey study of manufacturing productivity in Germany, Japan, and the United States concluded that global competition is essential “to stimulate operations to achieve the highest productivity; domestic competition alone is not enough.” Another study estimates that “the United States obtains over 40 percent of its productivity growth by building on foreign innovations.”

50
The Changing Contract and the American Economy: Problems and Challenges

There is also a dark side, however, to the changes that slowed growth, increased volatility, and intensified competition have wrought in the U.S. economy since 1973. The same slowdown in earnings growth that has contributed to the favorable shift in the inflation-unemployment rate relationship in the United States and to the durability of our latest economic expansion has disappointed the expectations of many Americans, conditioned by the faster growth of output, earnings and living standards in the postwar years. Many people feel that workers have not been receiving their fair share of this country’s economic growth, pointing to the gap between the growth of labor productivity and that of real (inflation-adjusted) wages, which has been growing since the early 1980s. In fact, however, this divergence disappears entirely when the same price index is used to deflate both services. Moreover, the shares of national income that go to employer compensation and to corporate profits, respectively, have been remarkably stable since the early 1970s, varying with the business cycle but without any discernible long-term trend.

Another effect of the changing social contract between employers and employees has been to shift the burden of adjustment to economic change: workers now bear a larger proportion of the transitional costs of adjustment than they used to. These costs take the form of an overall decline in job security, an increase in the proportion of permanent layoffs relative to temporary, and vulnerability to job loss in industries and occupations that had once seemed immune. These developments, and a rise in contingent work arrangements and in variable or contingent pay, all contributed to the more than 40 percent increase in the instability or variability of worker’s earnings between the 1970s and the 1980s.

Another aspect of the increased adjustment costs borne by workers is the doubling of the average duration of unemployment since the 1950s, with an especially rapid increase since the 1970s. Troublesome as this development is, however, the European experience suggests that efforts to preserve the old social contract in the face of changed conditions can be counterproductive. Most continental European countries try to reduce workers’ share of adjustment costs by imposing significant restrictions on layoffs and downsizing, together with downwardly rigid compensation and
generous unemployment benefits. Yet the average unemployment rate in the European Union is more than double that in the United States, and nearly half the unemployed fall into the "long-term" category (more than 12 months), as contrasted with 12 percent in the United States.

The fact that American workers today bear an increased share of the transitional costs of adjustment to economic change is making these costs both more visible and more politically sensitive, thereby increasing the threat of a protectionist backlash against trade, foreign investment, and immigration. In terms of overall effects on the quantity and quality of jobs, this antitrade sentiment is clearly misguided. There is no empirical support for the belief that an increase in trade, or even in our trade deficit, reduces overall job growth or increases the aggregate rate of unemployment. In fact, the pattern of 1997, when the United States simultaneously experienced one of the largest trade deficits and one of the lowest unemployment rates in recent decades, better typifies the observed relationship. Expanded trade, far from destroying good jobs, creates them. In recent years, wages at exporting plants have averaged some 15 percent higher, and benefits some 37 percent higher, than at nonexporting plants. Such plants also typically boasted higher productivity and faster growth of wages and employment than did nonexporters in 1976-92.

Despite these clear-cut benefits, expanded trade does impose a burden of adjustment and creates winners and losers. The jobs created by trade tend to be in different industries, different occupations, different communities, and often different regions of the country than those that trade eliminates. Studies of U.S. trade-protection patterns indicate that a major goal of such protection is to soften or delay the costs of trade-related adjustment in labor markets. It is hardly surprising, therefore, that a shift in the costs of adjustment that makes the losers in the process more visible and politically sensitive tends to intensify pressures for protection.

The most troublesome recent shift in U.S. labor market conditions is, without a doubt, the sharp increase in earnings inequality. The gap between high and low earners, which had been relatively stable throughout the 1950s and 1960s, expanded at an accelerating rate between the late 1970s and the mid-1990s. The impact of this growing gap was compounded by a sharp slowdown in earnings growth as a whole after about 1973. Men’s real wages, which had grown between 20 percent and 30 percent per decade between 1940
and 1970, grew only 5 percent in the 1970s and fell by more than 7 percent in the 1980s.

The combination of slowed earnings growth and increased earnings inequality, together with the growth of female-headed households and a drop in male employment in the lowest wage households, has had a magnified effect on total household incomes. Over the period 1979-93, real income rose by some 10 percent for the top 20 percent of households and declined for the other 80 percent, with the poorest 20 percent of households experiencing the steepest drop, about 12 percent. Although measurement problems exaggerate the size of these differences in experience among income groups, the picture remains a troubling one. Both the level of and the increase in earnings and income inequality, as well as the proportion of the population below the poverty level, are higher in the United States than in any other major industrial country.

Part of the reason for increased earnings inequality is an increase in the value of education in the workplace. The earnings premiums enjoyed by college graduates as compared to high-school graduates, and by high-school graduates as compared to dropouts, both doubled between 1979 and 1993. These widening premiums tell us that, although the average education level of American workers has been rising and the proportion of college graduates in the workforce increasing, the demand for highly skilled employees has been growing faster than the supply. There is widespread disagreement, however, on what has caused this shift in the demand for "human capital," that is, skills embodied in people.

The attention of politicians and the public has focused, once again, on the role of expanded international trade and investment in making rich Americans richer and poor ones poorer. The underlying argument is that it is the least-skilled workers in rich countries who are most adversely affected by competition in the form of growing imports from poorer nations. Although the controversy is ongoing, most economists think that trade's share in increasing earnings inequality is relatively small, probably between about 10 percent and 15 percent, while by far the most important factor is skill-biased technical change. Other factors, including increased immigration and the decline in unionization and in the inflation-adjusted minimum wage, all seem to play a smaller role.

No matter how hard we try to disentangle and weight the impact of various trends on what has been happening to the distribution of earnings in the United States, these factors remain
intertwined in ways we do not fully understand. Globalization, deregulation, and the advance of information technology have changed the organization of the American workplace in ways that put an increasing premium on the importance of skills and knowledge. These include flattening management layers, empowering workers with more autonomy and responsibility, and forging tighter links between pay and performance.

Adding to the inequality puzzle is the fact that the education premium accounts for only about one third of the total increase in earnings inequality; the other two thirds is attributable to widening gaps within a given education level, for example, among male high-school graduates. The same phenomenon is apparent no matter how we categorize people: earnings inequality has widened within the same industry, the same occupation, and the same age group as well as between such categories. Generally speaking, the gap has grown more within categories than between them.

One explanation for this development is that modern information technology, together with increased global mobility, has encouraged the expansion of what has been called the “superstar model” or the “winner-take-all society” by allowing a much larger number of potential customers to bid for the services of the very best performers in any field, be it law, medicine, business, or entertainment. The result is to increase enormously the demand for and pay of the very best people, or those who are perceived to be the best, while job opportunities and relative pay decline correspondingly for people who are not quite as good.

As of the mid-1990s, some preliminary indications suggested that the trend in earnings inequality may have flattened or even begun to decrease. Although a preponderance of the jobs created by the robust economic expansion that began in 1991 were “good”—relatively high-paying—jobs, the number of low-paying jobs also increased, as employment in the middle of the earnings distribution fell.

This “shrunk middle” phenomenon is reminiscent of the warning sounded in the 1968 Report of the Kerner Commission, that America was becoming “two nations, one black, one white, separate and unequal.”5 In recent years (between 1984 and 1995), earnings gaps based on race and gender have narrowed, while those based on different levels of education have widened. The good news is that race and gender are inherent qualities of human beings while differences in education can, in principle, be reduced if not eliminated by deliberate policy measures. The bad news is
that the social costs of failure to raise the skill levels of our least skilled citizens appear to be rising. As a social contract based on partnering replaces one based on paternalism, a major challenge to both public policy and private institutions is to prevent the nation from becoming increasingly bifurcated between people who are equipped for workplace partnership, and the opportunities it offers, and those who are not.

Labor-Market Differences and Pressures for Convergence

The nature of the employer-employee relationship is closely linked to the way a firm responds to changes, whether cyclical or structural, in the demand for its products or services. The United States represents one extreme among major industrial countries in the speed and sensitivity with which its labor markets respond to changing economic signals. In geographic mobility, job turnover, and short average duration of unemployment, we lead the industrial world. All these measures indicate a particularly heavy reliance on external (between-firm) as opposed to internal (within-firm) processes of adjustment to changes in demand or in production technology. Japan occupies the opposite end of the spectrum, with its low labor turnover, its policies of lifetime employment and finding alternatives to layoffs when demand slumps, and the tendency of its firms to respond to changing market signals with internal diversification and reallocation of labor. The nations of Western Europe lie somewhere in between; job protection, whether implemented through legislation or via a centralized industrywide collective-bargaining process, is considerably greater than in the United States but stops short of Japan’s “lifetime” commitment.

The alacrity with which American firms respond to market signals by expanding or contracting, being born or dying, underlies one of the most durable myths in American political economy: the belief that small firms rather than large ones are the United States’ primary engine of job-creation. The popularity of this view, which originated in some empirical research conducted in the late 1970s and the 1980s, has resounded in political speeches, newspaper columns, and statements from government agencies. Its policy results have included special tax incentives, fewer and simpler regulations, and other government programs that favor small business.

More recent research has demonstrated that this belief in the special job-generating capacities of small business is grounded in a number of statistical fallacies. The high birth rate of new firms in
the United States, owing to the uniquely high availability of venture capital, does indeed mean that small firms create a large number of new jobs, since virtually all firms are born small. But small firms also have a higher than average death rate, making them the source of disproportionately large job losses as well. The net result of these birth and death processes is that small firms’ share of total employment gives no sign of the rising trend over time that would result if such firms were indeed more effective creators of jobs than large ones.

The availability of venture capital and the rapidity with which firms are born and die do, however, underlie some of the particular characteristics of the U.S. economy and its labor markets. The United States has, for example, a far larger number and variety of firms in such high R&D- and human capital-intensive sectors as computer software, information technology, biotechnology, and entertainment media. This richness, in turn, is doubtless an important cause of the fact that both Germany and Japan have a comparative disadvantage in high-technology sectors compared to the United States.

This technological lead is not only a major component of the U.S. global competitiveness but also creates broader and more lucrative job opportunities for highly skilled individuals, while reducing the demand for and therefore the earning power of those without appropriate skills. Particularly when combined with the expanded opportunities for exploiting comparative advantage created by globalization, these developments are a major cause of the increase in earnings inequality in the United States.

As the preceding paragraphs suggest, changes in the implicit social contract between employees and employers can be seen as a rational response to changes in the economic environment confronting the United States and all other major industrial nations since 1973. One of these environmental changes is the slowdown in aggregate growth rates, a slowdown that demands downward adjustment, and thus the “hard” disciplines of the marketplace, in some firms and some activities. Another is the increased incidence of large and unanticipated economic shocks. Even the most enthusiastic supporters of internal labor markets—where adjustments to changes in output occur within a firm rather than between firms—acknowledge that, because custom exerts a strong inertial pull in these markets, their efficiencies are greater when change is gradual and predictable than when it is sudden and unanticipated.
Some of the same changes in the social contract are occurring in other nations as well, though nowhere as broadly or as rapidly as in the United States. For example, all the major industrial nations appear to be moving in the direction of greater reliance on external rather than internal adjustments to reallocate labor in response to market signals. A number of cross-country studies have noted convergence among these nations toward a weakening of employment stability and an increase in performance-related pay, which is inversely related to length of job tenure.

These developments are relatively recent, however. The fact remains that the post-1973 problems in labor markets, which in the United States have taken the form of wage stagnation and increased earnings inequality, have in Europe been manifested as rising and persistently high unemployment rates, particularly among the young. While U.S. wages are highly flexible, in Europe high minimum wages and rigid union rules prevent compensation from adjusting readily to changed demand conditions. And Japan, which for some time appeared to have avoided such labor-market difficulties, has experienced not only spreading underemployment but also rising unemployment since the onset of prolonged recession in 1991. In late 1998, the Japanese and the U.S. unemployment rates were both officially measured at about 4.5 percent. If Japan measured unemployment in the same way the United States does, however, its rate would be several percentage points higher.

Probably the most universal manifestation of heavier reliance on market-mediated reallocation mechanisms is the increased use of a peripheral or contingent workforce of temporary or part-time workers or contract business services. In the United States, temporary workers and business services have increased most rapidly since the early 1980s. In Japan, part-time employment has grown substantially while the proportion of temporary employees has remained relatively stable. In a number of European countries, the importance of both part-time and temporary employees has increased, particularly where restrictions on such "atypical" arrangements have been relaxed. Responding to opportunities created by such increased flexibility, the European branches of America's two largest temporary staffing firms, Manpower and Kelly Services, have been growing rapidly.

In Japan, where the ties that bind firms and their employees have traditionally been strongest, change has accelerated under the pressure of the prolonged economic stagnation and significant
weakening of the banking structure that have plagued the nation
during the 1990s. Among the unprecedented measures resorted to
by a growing number of large firms are short-term employment
contracts, layoffs, and the substitution of performance-based pay
for earnings based strictly on seniority. This last shift has resulted
in a substantial decline between 1970 and 1992 in the earnings
differential between long- and short-tenured college-educated workers
in manufacturing. A 1997 survey found that slightly more than 20
percent of Japanese firms were using performance-based rather
than seniority-based annual salary systems, up from 15 percent two
years earlier and from less than 10 percent in 1980. In Japan,
unlike the United States, these changes have fallen more heavily on
white-collar than on blue-collar workers.

The “social model” that characterizes employer-employee
relationships in much of continental Western Europe is predicated
on high minimum wages, generous unemployment and welfare
benefits, and restrictive employment-protection laws. But these
labor-market rigidities have been under increasing pressure from
persistently high unemployment rates, together with strict limits
on fiscal stimulus imposed by the membership requirements of the
European Monetary Union (EMU). The pressure is magnified by
several large European firms’ shift in expansion plans from high-
cost countries like Germany and Sweden to lower cost locations in
Eastern Europe or Asia.

In France, Germany, and several smaller European nations,
firms are downsizing and restructuring in the face of considerable
political and popular opposition. The largest French automobile
firm, Renault, closed an assembly plant in Belgium as part of a
program to increase efficiency through downsizing following its
first loss in 10 years, in 1996. It did so despite objections from the
French government and the European Commission, and a protest
march in Brussels by some 50,000 workers, and despite the fact that
the firm was until recently 100 percent owned and is still 47 percent
owned by the French government.

In Germany, the traditional practice of centralized pay setting,
whereby wages and working conditions for whole industries are
determined by agreements struck between union and management
representatives, is coming under increasing pressure. A number of
countries, including BASF, Bayer, Daimler-Benz, and Ford of
Europe, have negotiated their own individual pay agreements.
Daimler-Benz (now DaimlerChrysler) has introduced Saturday work
in some of its plants, despite a labor contract forbidding it. And in 1997 Volkswagen became the first German company to approve a stock-option plan for every one of its 92,000 employees, creating an American-style link between the interests of workers and shareholders.

As we shall see in greater detail in the essays that follow, differences in laws, customs, and institutions will continue to produce variations in the leading industrial nations’ responses to economic forces affecting them all. The conflicting pressures created by the combination of intensifying global competition, the constraints on independent monetary and fiscal policies imposed by EMU membership, and the political commitments of the social-democratic governments now in power in most of West European nations will make policy choices more difficult than ever. The threat that prolonged deflation and recession may turn into depression has increased the urgency of effective response in Japan. If the long-running expansion comes to an end and unemployment rises in the United States, a backlash increase in the protectionist pressures already building up is almost certain.

Whatever the differences in responses, all these nations will feel continuing pressure to experiment with new relationships between firms and their employees that increase the flexibility of their labor markets. The same paradox confronts them all, in that the very same forces of global integration, domestic deregulation, and privatization and advances in information technology that have intensified competition and stimulated downsizing and restructuring have vastly increased the power of consumers, including consumers of financial assets, investors. Every citizen is both a producer and a consumer, putting us at war with ourselves.

To citizens-as-consumers, the developments described here bring unalloyed gains in the form of lower prices, improved quality, broader choice, and higher returns on financial assets. It is hardly surprising that these changes have proceeded farther and faster in the United States than elsewhere, since it is on the welfare of consumers that American-style capitalism has traditionally focused.

From the point of view of citizens-as-producers, however, the effects are more complex and the blessings more mixed. The changes in labor markets described in this survey of the American scene have increased autonomy and expanded opportunities for many workers. They have also reduced economic security and increased income inequality, however, and neither the benefits nor the costs are distributed evenly across the population. The result is to burden
institutions ill-equipped to respond effectively and to pose new challenges for public policy. These challenges must be met if the global movement toward greater openness to competition—a movement that holds great promise for economic growth and greater material well-being—is not to succumb to social strife and political backlash.
Notes


2 As measured by gross national product, GNP, per worker.


7 As measured by the average of exports plus imports of goods as a share of gross domestic product.


9 OECD Economic Surveys 1994–95—Germany (OECD 1995), p.117, and Fukas, p.70. The average age of a listed firm in the United Kingdom, which shares with the United States many of the characteristics of what is often called “Anglo-Saxon capitalism,” is eight years, even shorter than in the United States.


13 International Monetary Fund, *World Economic Outlook*, May 1997, p.60. Note that these are gross purchases and sales.


18. Eberts and Groschen, p.23.
24. Ibid.
25. Ibid., p.316 and sources cited there.
26. Ibid., p.313.
27. Ibid., p.304.
III. Changes In Japanese Corporations

Shijuro Ogata*

The terms of reference for this study of the changing role of large corporations draw heavily upon the research by Professor Marina Whitman in the United States. The basic premise of this analysis is that forces intensifying competition among companies in advanced economies—globalization, technological advance and domestic deregulation—have interacted with local institutions and systems to change companies’ relations with society, notably with labor. Further, intensified competition combined with increased shareholder demands for higher returns is shifting power from corporate management to consumers and investors.

The situation is somewhat different in Japan. There the most powerful force pushing companies to reinvent themselves and their relations with other groups is the long recession that began with the bursting of the financial bubble in the early part of the 1990s. To be sure, the forces identified above have been at work in Japan, too, and for a considerable time. Increased affluence in the 1980s made government intervention in the economy less welcome, as Japanese industry wanted to give market forces freer play. Along with the resulting deregulation, globalization of production

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and finance and advances in information and communication technology, interfirm competition among Japanese companies, and restructuring efforts to meet the new environment. The paper is intended to describe the typical structure and practices of large and medium-sized public companies. It also provides a framework for examining how changes in these companies have been affected by the new environment. The paper is divided into two parts. The first part focuses on the new environment, and the second part focuses on the changes in the typical structure and practices of Japanese companies and how they are changing. I will focus on their relationships with their shareholders, employees, and communities surrounding them.

Since most of the changes under discussion are still underway, we hope to present comprehensive, statistically significant evidence. We have relied on anecdotal evidence and other descriptive work. The aim is to provide a framework for understanding the changes in the typical structure and practices of Japanese companies and how they are changing. We have relied on anecdotal evidence and other descriptive work. The aim is to provide a framework for understanding the changes in the typical structure and practices of Japanese companies and how they are changing.

The Way Things Were

Though there is quite a bit of variety among Japanese companies, the structure and practices of large and medium-sized public companies are quite similar. Small and medium-sized companies are often closely tied to the government and tend to be even today. Smaller companies, which account for the majority of the corporate labor force, are often closely tied to the government and tend to be even today.
The corporate structure and practices elaborated below seem to be based on the group consciousness that prevailed in Japan during the postwar years. Among factors supporting such group consciousness were:

- ethnic homogeneity;
- paternalism, according to which even members of large companies see themselves as one family;
- a strong sense of shared purpose—such as growth and/or continuation of their companies—among employers and employees;
- a relatively narrow income gap between top executives and ordinary employees; and,
- upward mobility of labor without stark social-class distinctions.

The combination of the above factors defines the typical postwar Japanese company.

**Relationship With Employees**

The basic feature of Japanese companies’ relationship with their employees is that the employers guarantee employees’ job security in return for the latter’s long-term loyalty. The centerpiece of the Japanese employer-employee relationship has been lifetime employment, or **shushin koyo**. Although lifetime employment existed on a smaller scale in the early 20th century, it was widely adopted and developed only after the war when larger Japanese companies needed to do something to attract and retain scarce skilled labor. This employment system has long resisted pressures toward change even when the system was becoming increasingly costly to maintain.

Large companies hire fresh college graduates once a year, usually in April, with the understanding that they will stay with the company until their mandatory retirement, or until the time the company arranges other jobs for the employee. Expecting long-term employment of their workers, Japanese companies give high priority to training and rotation of employees. Training is done mostly in-house and on the job, and most tasks the companies need done are completed internally, without hiring outside experts with specialized skills.

Companies do not keep their employees in the same job for long and routinely rotate them among different divisions. The
emphasis is thus on well-rounded employees with an overall knowledge of the company rather than on employees with specialized skills. This emphasis on the company's entire operation drives home the importance of teamwork as well as a decision-making process that is based on consensus, even if individual initiative is allowed at certain stages.

During the long employer-employee relationship, the employers reward workers' loyalty with seniority-based salary increases and promotions. While they are younger, employees are as a rule paid less, even when assigned to more important jobs than older employees. Then as they become older, they are paid more even if they work shorter hours than when they were younger.

Such a pay scheme, based more on seniority than on actual contribution, is a form of assurance of job security for life. Underpayment when employees are younger is supposed to be offset by overpayment when they become older, and the early exertion demanded of employees followed by generous compensation provides an incentive for them to stay longer with their original employers. The Japanese pay scheme also provides a substantial incentive to nurture the business. The more rapidly a business is growing, the more younger people the company can hire and the lower is the overall wage cost. This improves the company's competitive position.7

A seniority-based wage system reinforces long-term employment and minimizes rivalry among co-workers. More positively, this wage system is an attempt to ensure that as people grow older, they also increase their knowledge, skill, experience and flexibility so that they are more productive in various places throughout the company. Older people are very important in training the younger employees. Ideally, this provides the basis for the sustained productivity improvement achieved by the best Japanese companies.

But the seniority-based wage system can also result in inefficiencies when older workers do not live up to management expectations. It can also be costly and inflexible when slow domestic growth or intensified international competition create pressure for rapid cost reductions and redeployment of resources, as at present. Japanese companies have devised ways (including a relatively early mandatory retirement and use of temporary workers and subcontractors) to avoid the potentially high cost of being saddled with highly-paid but no longer highly-motivated senior employees.
Though there are some crafts unions and so-called industry unions (albeit not as cohesive and powerful as in the United States), most Japanese unions are company based, often identifying their interests with those of their companies, rather than with the interests of crafts, industry workers or union federations. These company-based unions tend to be more concerned with job security and working conditions than with nominal wages, and they aspire to no role in corporate management. This attitude is encouraged by the upward mobility of white-collar labor from union membership to managerial or even executive positions. Quite a few white-collar union members expect to participate in management after they become more senior and are no longer qualified as union members. Thus they are in no hurry to involve the union in management decisions.

Once a year, usually in early spring, almost all companies negotiate basic wages for the coming year with their trade unions. Although company-based unions are usually members of a broader union federation, the federation does not take part directly in collective bargaining with employers. It is the company unions that drive the spring labor offensive, or shunto. However, companies and unions in the same industry may try to settle on uniform terms for basic wages. But other rewards, such as bonuses, often vary widely depending upon companies’ performance.

Relationship With Shareholders

The key features of Japanese companies’ relations with their shareholders are two: cross shareholding, or mokai, in which related companies hold one another’s shares; and management by a corporate bureaucracy, with a minimum of intervention from individual shareholders.

To avoid hostile takeovers, particularly by foreigners, many Japanese companies hold shares of related companies with no intention of selling these shares for gain. This practice was initiated shortly after the war when the prewar zaibatsu, the family-owned conglomerates, were dissolved by the allied occupation forces. Cross shareholding was reinforced in the late 1960s when inward foreign direct investment began to be liberalized in earnest. Cross shareholding is often practiced among companies belonging to the same business group called keiretsu, or among companies that regularly do business with one another—including suppliers,
distributors, banks and insurers—even without specific group ties. In the case of some banks, their ownership of the shares of their clients is a form of credit extension over and beyond the legal lending limit to a single borrower.

Many Japanese companies are managed by what might be considered a self-perpetuating corporate bureaucracy. Most company executives were employed immediately after graduation from university and were then promoted to managerial and ultimately executive positions after many years of service. Since large shareholders are stable and non-intrusive cross shareholders, they are not usually interested in intervening in other companies' business. One exception among cross shareholders are the "main banks," which are the major lenders to companies. When companies develop financial problems, the main banks may decide to intervene, on occasion sending their own men as executives. Japanese companies often have no non-executive directors and if they do, these directors tend to keep quiet. Thus, those who manage Japanese companies feel little pressure from shareholders.

This fact is epitomized in Japanese shareholders' meetings, which for the most part are purely ceremonial events. Usually, the management unashamedly tries to make shareholders' meetings as short as possible. In order to avoid embarrassing questions, many companies still try to persuade "troublemakers" among shareholders—who are often indeed racketeers—to be cooperative at shareholders' meetings. This sometimes involves giving them financial favors, despite this practice having been prohibited by the commercial code. The assumption is that only "troublemakers" will ask "embarrassing" questions; common shareholders are not supposed to ask difficult questions.

One benefit attributed to this management system is the possibility of long-term planning with emphasis on R&D and quality control, rather than profit maximization every quarter for the sake of shareholders. However, without pressure from independent-minded, non-executive directors or common shareholders, corporate decisions tend to follow precedents or industry trends. Companies often expand when others expand and contract when others contract. During many years of rapid economic growth, Japanese managers were oriented toward the maximization of their market shares rather than rigorous pursuit of higher profitability, on the theory that an expanding market share would eventually bring forth
higher profits as well. Whether or not major shareholders agreed with the vision of building market share over the long haul at the expense of short-term profitability, they in fact did not pressure the management to go for higher short-term returns.

Relationship With Government

The basic feature of Japanese companies’ relationship with the government has been close cooperation rather than confrontation.

The Japanese government has implemented not only macroeconomic policy but also microeconomic industrial policy to promote and protect various industries. Industrial policy, according to those who practiced it, was the systematic selection of industries to be encouraged or discouraged by government action or deliberate inaction. Industrial policy entailed the use of various policy measures at the disposal of bureaucrats (subsidies, tax incentives, preferential financial schemes, and trade and exchange controls) to reallocate resources among industrial sectors and to influence the organization of specific industries in accordance with the government’s visions of a desired industrial structure. The Ministry of International Trade and Industry (MITI) was the principal designer and executor of Japanese industrial policy, shaping Japanese industry through directives and unwritten “administrative guidance.” For the most part, industries were willing participants in MITI’s industrial experiments, sending their representatives to governmental committees to provide their own inputs.

In addition to formulating industrial policy, the government has traditionally played a role mediating intra- and inter-industry disputes, again with industry’s acceptance. Industrialists often sought the government’s involvement in a mediating or coordinating capacity as insurance against being punished for infringing on anti-cartel laws and regulations.

Amakudari, literally “descent from heaven,” is another time-honored practice. Japanese officials, on early retirement, move to high positions in an industry with which they had worked closely during their government service. This is the Japanese version of the “revolving door” between government and industry in the United States. Amakudari had its origins in the early Meiji period when the government set up industrial and commercial undertakings to give jobs to otherwise functionless samurai.
Industry is not always the underdog, or the one taking direction, in the Japanese government-industry relationship. Various industrial sectors and broadly-based business organizations try to exercise pressure on bureaucrats, often through financial contributions to political parties or their factions. I refer to the so-called "iron triangle" of industrialists, bureaucrats and politicians that has shaped and moved Japan's postwar industrial society. Though one political party, the Liberal Democratic Party (LDP), dominated Japanese politics for nearly four decades, financial contributions were made to some opposition parties, too, as a kind of political insurance against the possibility of those parties coming into power in the future. Nowadays, as LDP dominance has become less clear-cut, industry's contributions to political parties are becoming noticeably more diversified.

**Relationship With Communities**

Professor Whitman discusses how large and successful American companies have had to make themselves socially and politically acceptable by sharing widely the fruits of their success. This was in addition to competing successfully against other companies, turning out a continuously improving stream of products, and earning steady and reliable profits for investors. Philanthropy has been one way for American corporations to take on social responsibility and share with the community.

In Japan after the war, income distribution among individuals was equalized through progressive direct taxation, decreasing the number of very wealthy people. Furthermore, the tax system has never been generous toward private philanthropic contributions. In such an environment, companies and business organizations in Japan have emerged as the more important source of funds for philanthropy. Some business organizations have gone to the extent of allocating contributions among participating industries and companies, in support of a broad range of social objectives.

Environmental concerns did not enjoy high priority during the period when growth was of paramount importance to Japanese companies and society at large. Companies did the minimum toward keeping the environment clean. But given today's increased awareness of environmental damage caused by industrial development, many manufacturing companies have become more conscious of environmental protection. However, there remain many unresolved disputes between industries and residents of industrial towns and cities.
Factors For Change

The proposition set out in the introduction is that modem corporations are being forced to change as they confront intensifying competition brought on by the globalization of production, technological advances and domestic deregulation.

While globalization and technological advance have affected Japan just as other countries, the single most important impetus for such change in Japan has been the long recession that started with the bursting of the financial bubble in 1990. To be sure, gradual change in the postwar structure and practices of large Japanese corporations began to take place as early as the 1970s under pressure from the two oil price shocks of that decade. The decisive turn in Japan’s current account from negative to positive in the early 1980s induced greater outflow of direct investment as well as increased adoption of international standards in running businesses. Increased affluence during the 1980s produced, among other things, a desire on the part of industry for less government intervention and more free play for market forces. Gradual deregulation ensued, particularly in the manufacturing sectors, and MITI slowly lost its power to implement industrial policy. Finally, these changes also reflect a slow but more fundamental change in the Japanese character toward greater individualism.

Economic developments have been most important. The emergence of a persistent current account surplus in the 1980s gave a considerable jolt to Japanese companies. After recording a surplus in the mid-1970s and returning to deficit in 1979 and 1980, Japan’s current account chalked up another surplus in 1981 and has been in surplus ever since. Many Japanese companies have revised their corporate strategies as a result. In the face of the stronger yen vis-à-vis the dollar and rising protectionism abroad against Japanese exports, Japanese companies started to increase outward direct investment, thus shifting part of their operations abroad. Japan’s direct foreign investment grew steadily during the 1980s, jumping to a peak of $67.5 billion in 1989 alone. Investment in the United States also surged; in 1984, the figure surpassed $1 billion and annual Japanese investment in the US has stayed above $1 billion ever since. According to the Bank of Japan’s Tankan Survey of December 1998, the share of overseas investment in total investment of 183 major manufacturing companies was as high as 34 percent in 1997 and 1998.
Increasing contacts with foreign partners through trade and investment and the growing importance of Japanese products in global markets led Japanese companies to recognize the greater need to comply with internationally-established rules and practices. In the early 1990s, Akio Morita, then chairman of Sony Corporation, became a powerful voice stressing the need for Japanese companies to respect internationally-established practices in business in pursuing their global operations.

At home, many industries and companies called for increased freedom from government-imposed restraints. Greater abundance of goods and services had anyway eliminated the need for the government to ration scarce resources. Advancement in educational and living standards naturally strengthened demands for greater choice in economic activities from the public (in its capacity as consumers and laborers). The stronger private sector, both at the individual and corporate levels, began to question the need for "industrial policy" and government intervention generally, and demanded deregulation—with some success.

In the 1990s, the prolonged recession turned into an engine for change. After Japanese asset markets crashed early in the decade, companies were forced to rationalize and restructure their management more drastically than ever before. Change was imperative, given prolongation of the recession coupled with ever greater exposure to rapidly globalizing flows of information and capital which were in turn accelerated by innovations in the telecommunications field.

For a variety of reasons, including increased flow of information and wider contacts with the outside world, younger Japanese people are becoming more individualistic, if not egocentric, and less group-oriented than their forebears. The pace of such change remains gradual because of the resilient, standardized education which reflects Japan's egalitarian and conformist society. Nevertheless, the change in Japanese youths is fed by changes in corporate Japan, which will in turn feed further changes in the Japanese character.

**How Things Are Changing**

After the external developments of the 1970s and 1980s and recession of the 1990s, many new trends have become observable in Japanese corporate structure and practices.
Relationship With Employees

Companies' relationship with employees is being rationalized, as the old system, centered on lifetime employment, has become grossly inefficient and costly.

The lifetime employment system is being eroded, as companies are no longer willing or able to pay its price. As an indication, some companies have started to recruit not only fresh graduates but also those with some previous working experience from other companies. Also, recruitment is now conducted not only in April but also at other times during the year, as it becomes necessary. According to a June 1998 Ministry of Labor survey of over 4,802 companies with more than 30 employees, 10.6 percent had started to recruit all year round, with 4.9 percent planning to do so and 28.0 percent seriously considering it.

Some companies have also been giving their employees the option of receiving a fraction of their future retirement allowances along with their current monthly wages. For example, in December 1997, Matsushita Electric proposed to its 38,000 employees a new scheme that would enable them to choose a fractional advance payment of their retirement allowances; 41 percent of the employees (and 44 percent in the case of the 814 who were newly employed in the spring of 1977) opted for the scheme. This suggests that employers are increasingly tolerant of mid-career job changes, and it also reflects the difficulty they face in managing their pension funds under current financial conditions. In view of the extremely low returns on financial investments, some companies are studying whether they should adopt a pension scheme similar to the 401K plan in the United States. This would give still greater investment responsibility to employees while limiting the contribution of employers, and may further increase the mobility of labor.

The mobility of Japanese labor is increasing in other ways. Some young workers, including those employed by well-established companies, are now opting to change jobs or professions after several years of working experience. Others are forced to change jobs involuntarily, due to the failure of, or difficulties faced by, their employers' business. Greater penetration of foreign firms into Japan, particularly into its financial markets, is intensifying such trends.

As the lifetime employment system and along with it the seniority system are eroded, promotion based on merit is becoming
more common. Already, in many companies, the seniority system has retreated in one way or another. As early as May 1993, Hitachi announced it would reduce the seniority-based portion of salaries for 30,000 trade union members from 60 percent to 40 percent over the following three years. In March 1998, Mitsui & Co. announced that it would abolish its seniority-based pay scheme as of April 1999. According to a 1998 study by the Japan Personnel Administration Institute, 28.8 percent of companies listed on the Tokyo Stock Exchange have changed their pay schemes during the previous two years.

Merit-based pay and promotion schemes are increasingly being adopted by companies as a way to obtain and maintain a higher quality of labor. Significantly, even one of the trade-union federations in the electronics industry issued a public statement in July 1998 admitting the inevitability of the shift to merit-based schemes. Experts argue that the shift from a seniority-based to a merit-based system of labor management will lead to greater emphasis on specialists rather than generalists in recruitment, training and placement. This represents another departure from the prototype postwar Japanese company.

Due to greater diversity of performance among industries and companies and to decreasing unionization (down to 22.6 percent in 1997), it has become difficult for unions to conduct the traditional “spring offensive” wage negotiations.

In addition, in the face of the protracted recession, companies have been making adjustments to their employment practices, as well as to their investment, production and inventory policies. Such employment adjustments include:

- cuts in bonuses, overtime pay and wage increases;
- layoffs of part-time workers;
- relocation of employees to subsidiaries or sub-contractors;
- reduction of recruitment of young workers, and
- encouragement of early retirement of older workers

These trends are already worrying for employees who thought they had been guaranteed stable employment for life. But the depth and length of the current recession will most likely require more drastic cuts, even to middle-aged employees, in the coming months.
Relationship With Shareholders

Companies' relationship with shareholders, too, is being radically altered as cross shareholding becomes increasingly difficult to maintain.

Depressed stock prices and declining dividends are forcing many companies to reduce cross holding of shares with other companies, though it is said that the percentage of cross-held shares is still high, at around 35 percent, after coming down from around 40 percent a decade ago.  

The importance of "main banks," which used to be the principal suppliers of credit to non-financial companies, declined due partly to increased reliance by companies on direct access to capital markets at home and abroad, and partly to the stagnant overall demand for credit. Similarly, the importance of ties between major companies and their subcontractors through keiretsu has been declining because the prolonged recession has encouraged diversification of business transactions. Major companies sometimes find it difficult to support the keiretsu sub-contractors and prefer to transact with efficient units—be it parts suppliers or dealers—outside the keiretsu.

Two examples in the automobile sector point toward a weakening of keiretsu relations. In an attempt to deal with depressed markets due to the prolonged recession, many small producers of automobile parts usually linked with Honda Motors are reportedly trying to establish or strengthen their business ties with Isuzu Motors. For its part, Toyota Motors decided to develop business ties with high-quality producers of automobile parts, including some Japanese subsidiaries of foreign companies, which had previously been excluded from Toyota's keiretsu network.

The demand for improvement of corporate governance is growing stronger due to such factors as the revelation of unethical and/or illegal relations between company managers and racketeers or regulators; stronger requests from some foreign shareholders for their representation on company boards; and increasing recognition by the corporate bureaucracies that they have made wrong decisions in recent years.

An increasing number of companies have appointed "executive officers" outside the board of directors. These officers are authorized to carry on day-to-day operations and are required to report to the board. In order to motivate these officers as well as regular board members, 154 companies have already introduced stock options. At the same time, companies are intensifying efforts to:
• enhance the role of auditors and non-executive directors;
• change the character of shareholders’ meetings from ceremonial gatherings to forums for substantive discussion;
• shift business emphasis from market share to profitability;
• improve disclosure and transparency; and
• secure better compliance with internationally-established accounting rules and rules of conduct generally.

Progress in all of these areas has been slow, however.

Further, Japanese companies are moving toward greater empowerment of locally-employed managers in overseas subsidiaries. This development is partly a step toward rationalization of corporate management, though here too the progress is slow. But this trend toward decentralization is in contrast to the earlier situation in which overseas operations were almost entirely directed from headquarters in Japan, with very limited delegation of authority to locally employed managers.

Relationship With Government

Government’s role in industry has gradually been reduced in manufacturing but less so in services, notably finance, which is only now being liberalized with great pain for the companies involved.

Generally speaking, manufacturing industries have been liberalized and deregulated, and thus exposed to international competition. Manufacturing’s reliance on the government had already been reduced by the time the long recession set in. But service industries, particularly financial institutions, are another story. This sector has been over-regulated in many areas, though under-supervised in some vital areas and over-protected in times of difficulty. As a result, a dubious relationship has developed between regulators and the regulated. To wit, disclosure of enormous bad debts and restructuring of banks have been much delayed.

Now, however, two groups within the government seem to be accelerating reforms. First are the prosecutors, whose investigations into scandals have forced many companies to cut unethical and/or illegal relationships with racketeers as well as with regulators and to improve their corporate governance. The other group is made up of the newly established Financial Supervisory Agency and Financial
Reconstruction Commission which together have begun to take strong actions to force a quick restructuring of banks, including mergers and nationalization. Of course, voluntary reforms by the private sector would have been better, but without official intervention the pace of reforms would have been much slower.

The private sector in general has begun to review its relations with the government. One result is that amelioration, the re-employment of former government officials, has become increasingly difficult. The relationship of companies and business organizations with political parties is also being reexamined.

Relationship With Communities
The long recession is a negative influence on the development of corporate philanthropy in Japan. However, Japanese companies have not retreated from environmental consciousness.

The recession has made it even more difficult than before for many companies and business organizations to make financial contributions to philanthropic and other civic projects. The foundations established by companies and business organizations for such purposes in boom years now suffer from almost negligible investment returns on their basic assets, and they have either to cut their activities or solicit additional donations from their parent or member companies, few of which are doing well.

However, some companies have established schemes under which employees can take months or even years of leave, in some cases with pay, to participate in voluntary activities contributing to social welfare or to international cooperation. It remains to be seen whether such schemes will be maintained despite the prolonged recession.

Partly because of greater demand from environmentalists, consumers and mass media, companies are generally more aware of their responsibilities for using environmentally-sound methods of production and making environmentally-sound products. Thus, the importance of customers and general public as stakeholders is much better recognized by many companies in this area. While many disputes remain unresolved on environmental issues, new legislation has increased the legal responsibilities of producers for their products.
Conclusions
What is in store for Japanese companies and their employees? How much more will they change before some equilibrium is reached? There are a few important factors to consider in this regard.

The first factor to consider is the ongoing recession, which, as I have argued, has been the biggest cause of change in Japanese corporate structure and practices. What will be the depth and duration of the recession? Generally speaking, if the recession had ended sooner, there could have been a return to early postwar forms and practices, including lifetime employment and cross shareholding. But the recession has lasted long enough and looks like it will be continuing for some time. As a result, Japanese companies could not avoid changing at the core. On the other hand, the recession could become so serious that policymakers would decide to postpone restructuring and stress macroeconomic recovery.

But considering the situation as it is developing, my sense is that the above-mentioned changes in corporate structure and practices will not only continue but will accelerate in the near-term future.

The second factor to consider is the magnitude of pressure for change coming from globalizaton of production and finance. After the outbreak of the Asian crisis, the problems of free flow of capital have emerged as a major topic of debate. Malaysia, in particular, has introduced capital controls. There is other evidence of backlash against globalization. How much will these counter-globalization trends affect Japan? I am inclined to believe that the Japanese economy is now too large and too internationally-exposed to allow anyone to control it directly. In other words, the international pressure towards globalization is not likely to recede as far as Japanese economy is concerned.

Finally, of the many peculiarities of Japan's early postwar corporate structure and practices, which ones will be more resistant to change than others? My feeling is that, as long as Japan manages to retain its present ethnic homogeneity, the attachment of the Japanese people to job security—which I believe is stronger than in many other developed countries—will remain intact. However, I am fully aware that unless the economy restores a certain degree of positive growth, the dilemma between job security and productivity gain (and survival of companies) will increase, rather than decrease.
Notes

1 Japanese census figures show that in manufacturing, large companies with 500 or more employees have accounted for just over 1 percent of the total number of manufacturing establishments and for about one third of the manufacturing labor force.

2 I owe this and other insights to Mr. Roderick Carnegie, a fellow member of the Group of Thirty and this study group, who kindly commented on an earlier draft of this paper. Having spent considerable time in Japan as an objective outsider, Mr. Carnegie has a keen sense for the less obvious rationales behind the prototype postwar Japanese company.

3 In this connection, it is interesting to note a newly emerging tendency of young people to stay longer at universities. While the reduction of recruitment of young labor has been the major form of employment adjustment, many families have become more able to support their children going to universities because of the decline in the number of children per family. Nevertheless, applications for exemption or deferred payment of tuition are said to be increasing because of the adverse impact of the prolonged recession on parents. Thus, the burdens of employment adjustment are being transferred to youngsters, their parents, and their universities.

4 According to Nisshin Research Institute's report on September 21, 1998:

- The percentage of "stable shareholding" (the sum of (i) bilaterally-held shares between two listed companies, (ii) shares of listed companies owned by banks [excluding trust banks] and life insurance companies, and (iii) shares of banks [excluding trust banks] held by listed non-financial companies) to all the shares in market value was 33.60 percent as of end-March 1998, compared with 41.53 percent as of end-March 1988.

- The percentage of "stable shareholding" (as defined above) in the total shares of non-financial companies was 22.60 percent in 1998, compared with 26.20 percent in 1988; banks was 48.31 percent in 1998, compared with 56.46 percent in 1988; and the Mitsubishi, Sumitomo, Mitsui, Fuji, Daiichi-Kangyo and Sanwa groups was 46.72 percent in 1998, compared with 55.96 percent in 1988.
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IV. Germany: Between Corporatist Stability and Corporate Flexibility

Gerhard Fels, Jürgen Matthes, and Claus Schnabel

The German social market economy model has lost its glamour. Its basic features—welfarism, egalitarianism, and corporatism—do not seem to fit in the age of globalization. Its problems in coping with global economic integration, intensified international competition, and structural change also show up in other continental European countries of similar design, which all suffer from high unemployment. Some observers, such as Michel Albert (1991), speculate that the social market economy model ("Rhine Capitalism"), with its emphasis on collective achievement, social consensus, and long-term orientation, is being phased out, soon to be replaced by the Anglo-American model, based on individual achievement and short-term profits. The strong emphasis on shareholder value in the Anglo-American model cannot only be expected to reshape corporations' relations with their shareholders and stakeholders but might also herald the end of the stakeholder society that has been typical of Germany in the last 50 years.

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The social market economy model was adopted in West Germany after World War II while rebuilding a broken economy and a shattered society. The reliance on capitalism and market forces was combined with a guarantee of social security. Over time, as the initially basic social system became more and more generous, it turned into an expensive welfare state. At the same time, egalitarianism—traditionally more pronounced in Europe than in Anglo-Saxon countries—was pursued through wage policy and income redistribution.

This system broadly supports stability of existing economic structures, for example, by subsidizing agriculture and old industries or by making generous provisions for job security. Corporatism within a network of long-term relations further contributes to a stable (but often inflexible) socioeconomic framework. Firms are regarded as social institutions, not just as the property of their shareholders. Employees, trade unions, and various other stakeholders have a strong say in corporate governance and in labor relations through legal requirements for power sharing and through the traditional principle of consensus seeking. Joint governance of labor markets by encompassing employers’ associations and trade unions is so firmly established that “by the 1980s Germany had become the only major economy in which the ‘postwar settlement’ between capital and labor remained intact.” (Streeck 1997, p.243).

For a long time during the postwar period, this economic model was rather successful and managed to accommodate simultaneously the competitive pressures of international markets as well as domestic demands for equality and social cohesion. Capital could prosper in a stable socioeconomic environment, characterized by steady (though decelerating) economic growth, high savings rates, social peace, and very few strikes. There was a close relationship between banks and industrial corporations, which meant that invested capital could not easily be liquidated, and stable bargains with organized labor allowed firms’ management to take the long view. These arrangements and institutional constraints that make low-cost production prohibitively costly also enabled and forced German firms to pursue a high wage—high quality strategy of production and a pronounced export orientation. Long-term employment stability raised employers’ and employees’ incentives to invest in the development of labor skills, a prerequisite for high-quality production. Social security provisions enabled
economic actors to take risks when searching for better income possibilities but may also have limited their incentives to do so.

By the 1980s, slower economic growth and increasing unemployment indicated endemic weaknesses stemming from the institutional rigidity of the Rhine model. In the 1990s, the economic shock of unification has put additional pressures on the German model. Now, the basic pillars of Rhine capitalism seem to be continuously eroded by globalization, increasing international competition, and technological progress. Welfarism and particularly income redistribution are limited by intensified locational competition. As international investors become more and more mobile, the rising costs of the welfare state in an aging society can no longer be shifted easily to employers. Both stronger competition from low-wage countries and skill-biased technical change lead to unemployment among the low-skilled, unless egalitarianism is reduced by widening the narrow wage dispersion. Structural change toward skill-intensive markets and toward the service sector demands a greater flexibility of business and society, which often clashes with corporatist tendencies to preserve socioeconomic stability and consensus seeking. The stakeholder orientation in corporate governance is further limited by the increased power of shareholders and the growing importance of capital markets. The rise of the shareholder-value ethos and German firms’ movement toward internationalized production strategies both put great strains on labor relations and corporatism as a whole.

Systems built on social consensus rather than individualistic competition may find it harder to promote the flexibility required by rapid global integration and technological progress. Thus, Germany’s prospects seem to be bleak in the current economic situation, characterized by transformation problems in post-communist eastern Germany, jobless growth, persistent unemployment of more than 4 million people, and neglected employment opportunities in the service sector. Problems are reinforced by West Germany’s response to unification—a wholesale transplanting of all its institutions and corporatist settings, with all their institutional rigidities, to the former East Germany, instead of taking unification as a starting point for revitalizing the social and economic order. Announcing the demise of the German model may be premature. Nonetheless, recent worldwide economic developments do pose a serious challenge for German politics, business, and
society, testing the social market economy’s ability to adapt to a fast-changing environment. How, then, are Germany’s corporations, labor relations, and social policies responding to the pressures of globalization, shareholder-value considerations, and technological and structural change?

The German Model: Characteristics, Strengths, and Weaknesses

The German system of corporate governance, corporatist labor relations, and the welfare state, have important strengths and weaknesses.

Corporate Governance

The German system of corporate governance, with its pronounced stakeholder-orientation,3 differs markedly from the system in Anglo-Saxon countries. The predominance of stakeholders’ interests over shareholders’ vested interests in managerial decision making is founded on a variety of institutional and regulatory features of the German economy.

The supervisory board (Aufsichtsrat) is of prime importance. Larger incorporated firms (Kapitalgesellschaften)—joint stock companies (Aktiengesellschaften) or corporations with limited liability (Gmbh), with more than 500 employees—are required by law to have a two-tier board system. The management board (Vorstand) conducts the operational business. The supervisory board appoints and controls the management board and participates in strategic decisions. Although the supervisory board must act in the best interest of the company, it is mainly through this institution that stakeholders influence the governance of German firms. Members of the supervisory board usually represent banks, important customers, other corporations, governmental institutions, and, from the labor side, trade unions and employees.

Employee representatives are granted special rights by the legal principle of codetermination. In incorporated firms with more than 2,000 employees, they supply half of the members of the supervisory board, with a minority of these representatives being trade unionists. The other half of the board is elected by the annual shareholders’ meeting for five-year terms. In case of voting parity, the chairman, usually from the employer’s side, casts the deciding
vote. In smaller incorporated firms with a two-tier board, one out of three members of the supervisory board must be an employee representative. The system of codetermination also extends to unincorporated firms, stipulating that, in each private company with more than five employees, a works council (Betriebsrat) can be elected, which is given extensive rights of information, consultation, and codetermination.

In Germany, banks are considered to be influential stakeholders as well, mainly because of their multiple relationships with companies. As creditors, they often act on a long-term basis (Haushalt) and exercise a substantial degree of surveillance, particularly in smaller firms. With regard to joint stock companies, banks are allowed to hold shares, send representatives to the supervisory board, and execute proxy voting rights, often delegated by smaller shareholders without specific instructions. However, the role of banks in Germany tends to be exaggerated. On the supervisory boards of the 100 largest German firms, for example, private banks held only 6 percent of all mandates in 1993 (Bundesverband deutscher Banken 1995). While banks are the most important provider of external finance, bank loans have accounted for 25 percent and less of producing enterprises’ financial resources since 1992. Between 54 percent and 73 percent of producing enterprises’ financial resources have been internally generated during this period (Deutsche Bundesbank 1999). Nevertheless, due to the different channels of influence, there can be no doubt that some of the larger banks in particular play a much more important role in German corporate governance than do their counterparts in Anglo-Saxon countries.

Apart from banks, producing enterprises also exert important governance functions in Germany. Since 1960, they have held more than 40 percent of total shares in circulation in Germany (Sherman and Kao 1997). Roughly three quarters of the equity interests of domestic producing enterprises consist of interlocking shareholdings (Deutsche Bundesbank 1997). Personal interconnections via the supervisory boards further strengthen these ties. Between 1986 and 1993, representatives from industrial companies held more than one in four seats on the supervisory boards of the 100 largest German companies (Bundesverband deutscher Banken 1995). All in all, shareholdings in Germany are significantly more concentrated than in the United States or the United Kingdom in firms and banks.
but also in a few private owners and foundations (Sherman and Kael 1997). By implication, dispersed private shareholdings are of little relevance. Private households own about a sixth of total shares in circulation in Germany, compared to roughly one third in the United States and the United Kingdom (Deutsche Bundesbank 1997). However, after a decline since the 1970s the holding of equities has become more popular since 1995. This is possibly related to the stock market boom in recent years and to the much advertised listing of the Deutsche Telekom AG. Likewise, institutional investors play a significantly smaller—but slowly increasing—role than in Anglo-Saxon countries. Hostile takeovers—a means to discipline the management board—are virtually unknown in Germany. They are also socially unacceptable, as shown by the failure of the unfriendly takeover of Thyssen AG by Krupp AG. Moreover, owner-controlled firms clearly predominate in Germany, where joint stock companies account for little more than 0.1 percent of all enterprises (Monopolkommission 1998, p. 30). In sum, the stock market—as a potential actor in corporate governance—is much less relevant in Germany than in Anglo-Saxon countries. Germany’s stock market capitalization in 1997 amounted to only 39 percent of GDP versus 129 percent in the United States and 135 percent in the United Kingdom (Deutsche Bundesbank 1998a). In 1995, the United States also had 20 times more venture capital than did Germany (Monopolkommission 1998, p. 65). Thus, the access of young innovative firms to equity capital is often considered insufficient in Germany.

One reason for the lack of venture capital in Germany may be that a bank-based system makes risk capital formation more difficult. Structural asymmetry discourages the formation of venture capital in the form of bank loans: lenders do not share in potentially large future profits (as providers of equity do) but do risk losing the loan. A conservative lending policy may also result from the fact that young enterprises are usually hardly able to provide security. Their stock market introduction tends to be impeded by risks for the syndicate banks’ good name as well as by the banks’ liability for the contents of the prospectus and for their investment advice to clients.

Other, more general reasons contribute to the small significance of the stock market in Germany. Small and medium-sized enterprises
have been restricted from accessing the stock market (for example, due to minimum capitalization standards) or have had little incentive to seek equity finance due to various listing requirements concerning codetermination or increased publicity (Deutsche Bundesbank 1997). Some of these restrictions have been abolished or reduced, for example, by allowing for less regulated forms of stock-market listing or by introducing the legal status of a small joint stock company (Kleine AG). Nevertheless, disincentives remain, and minimum listing requirements still keep small and newly established companies from entering the stock market. As regards existing joint stock companies, the taxation system—despite some reforms—still puts equity financing at a disadvantage in comparison to bank loans and the formation of internal reserves for pension provisions.

Still other factors contribute to the small relevance of the capital market, particularly the stock market, in Germany. Capital market liquidity is restrained by the way provisions for old-age pensions are organized in Germany. By far the largest part is financed on a statutory pay-as-you-go basis and, among different forms of additional corporate retirement funds, the formation of internal pension reserves predominates. By implication, the relevance of pension funds, which are common in Anglo-Saxon countries, is small. With regard to private savings, after the first six months no tax is levied on gains from rising share prices, but overall the taxation system favors other forms of investment, for example, life insurance and real estate. This disincentive to invest in equities is reinforced by German accounting practices, which allow the build-up of hidden reserves. Compared to Anglo-Saxon countries, the transparency of companies’ finance and profit distributions to investors is thus reduced. This effect is aggravated by the right of the two-tier board to withhold up to 50 percent of earnings. In fact, empirical evidence suggests that the share of distributed profits in total profits is much lower in Germany than in the United States (Augustin 1994).

Regulation and legislation have also played an important role in shaping the stakeholder-based governance system, as mentioned in connection with the legal provisions for the supervisory board and for codetermination. The particular influence of banks stems in part from the relatively few restrictions placed on their ownership of stock, which—in contrast to the United States—enables them to be lenders and equity holders at the same time (Shleifer and Vishny).
1997). Their influence is also founded on the better protection of creditors in relation to providers of equity in case of default (OECD 1995, p. 116).

The German and the Anglo-Saxon systems of corporate governance differ considerably in various respects. While under the German firm- and bank-based concept, stakeholders control management from within, in Anglo-Saxon countries the stock market and shareholders, particularly institutional investors, exercise surveillance from outside. German governance structures can be seen as a network of long-term relationships among stakeholders and management, based on implicit contracts and objectives such as a firm's stability, lasting ties with banks, suppliers, and customers, and an inclination toward permanent employment. What is more, a large German company is considered an "entity in its own right," one that can legitimately pursue general welfare goals (Schmidt et al. 1997, p. 30).

Evaluating the German system of corporate governance in terms of effectiveness, some theoretical arguments suggest an advantage over the Anglo-Saxon system. More concentrated shareholdings and the influence of stakeholders—banks in particular—increase the ability and the incentive to monitor management. Thus, the free-riding behavior of stockholders is inhibited when stocks are widely held and information asymmetry is larger. Control by "insiders" also implies less friction than capital market control by hostile takeovers. Mainly for these reasons the German system has been favorably discussed in the United States (Rock 1995). However, several big supervisory board failures to prevent mismanagement and serious financial crises have raised substantial criticism of the German governance system (OECD 1995, p. 119). In particular, the potential for "insider" collusion among stakeholders, by limiting external control through shareholders, has been criticized (Monopolkommission 1998, p. 93).

Concerning the increased requirements for flexibility posed by globalization and technical progress, it can be argued that the German system of corporate governance slows down structural change. Generally, a small capital market obstructs the rapid and smooth redeployment of resources between declining and growing sectors. The virtual absence of hostile takeovers aggravates this problem. The lack of venture capital can slow down the move toward new, innovative, and rapidly growing markets. In this respect, Germany's weak position in top-quality technology such as microelectronics or bio- and information technology relative to
the United States and Japan is especially striking. Furthermore, the stakeholder network’s long-term focus on stability is prone to impede a change of existing structures in incorporated firms. The principle of seeking consensus and compromise may delay decision-making and makes it less effective. To the extent that the governance system allows for “insider” collusion, it may also contribute to excessive retentions of profits, implying a “preservation of product lines” (Nunnenkamp 1995, p.26).

Corporatist Labor Relations

Labor relations in Germany are part of a system of corporatist group self-government that often delegates governance to certain organized groups and associations or to collective negotiations between them. This practice has resulted in “joint governance of labor markets by employers’ associations and centralized industrial unions” (Streeck 1997, p.243). Widespread organized cooperation between labor and capital ranges from employees’ codetermination at work-place and company level over collective bargaining at the sectoral level to the tripartite governance of the Federal Labor Office by unions, employers’ associations, and the federal government. Structural conflicts between labor and capital are dealt with using a dual system of interest representation. While unions and employers’ associations are responsible for sectoral collective bargaining, works councils and management shape labor relations at the company level. Although both groups of actors are formally independent, in reality they are mutually dependent, which results in a network of stable cooperation (Jacobi et al. 1998).

Within this system, special importance is given to centralized collective bargaining, which predominantly takes place at the sectoral level, and here usually not at the federal but at the regional level, covering one federal state or a part of it. Multi-employer sectoral bargaining determines blue- and white-collar pay (usually annually) as well as job classifications, working time, and working conditions (over more than a year). Regional negotiations within one sector are closely coordinated by the officials of the appropriate sectoral trade union and employers’ association, so that variations between them are small. Even between sectors there is some coordination by unions and employers in their behavior, which has led to an increasing uniformity in collective bargaining policy.

Although not more than two out of three firms are members of an employers’ association and less than one third of employees
belong to a trade union, collectively negotiated wage contracts cover more than 70 percent of the German work force. This is due to two special institutional features:

- Constitutional law in Germany rules out any different treatment of unionized and nonunionized workers such as union-wage differentials or closed shops.
- Industry-level contract wages are regarded as minimum wages and can be extended by government regulation to all employers and workers in the industry, including those not represented in the original negotiations.

There is, however, no minimum wage legislation, and the collectively agreed norms are therefore minimum terms and working conditions. Companies bound by sectoral agreements cannot undercut, only improve upon, these terms and conditions through voluntary premiums (such as higher wages or more holidays). Because collective agreements are often settled uniformly for the whole sector with only minor regional differences, wage differentiation between regions, sectors, and plants is difficult and costly to achieve, by plants paying premiums over and above the contract wage.

The facts that collectively negotiated wages in Germany serve as minimum wages (generous by international standards) and that opportunities for wage differentiation are limited both have turned increasingly into a problem (Schmoller 1998). This is obvious in eastern Germany, where unions have been driving hard for wage convergence to western standards—with detrimental consequences for employment. In 1997, basic monthly wages in the east reached about 90 percent of the western German level, but fringe benefits were generally lower, so that effective wages were just about 77 percent of the western level. Since average labor productivity was even lower (62 percent of the western level), average unit labor costs in eastern Germany are still considerably higher than in western Germany. Therefore, to stay in business many companies are forced to pay less than the collectively agreed minimum wages, mostly through informal agreement with their work force. For companies bound by collective agreements, this is a violation of the law, but the collective bargaining parties tacitly put up with it.

In western Germany, there are sufficient reasons, too, for reforming the wage-bargaining system. In the past, nominal contract wages in western Germany usually increased in line with productivity and consumer prices, with unemployment exerting just a minor
dampening effect on wage rises (Carruth and Schnabel 1993). By ignoring the interests of unemployed "outsiders" and redistributing productivity increases resulting from layoffs, the unions—which mainly represent the employed "insiders"—pushed through excessive wage increases. As a result, temporary employment losses became permanent.

A period of wage moderation in the 1980s was followed in the 1990s by a series of high wage increases, exacerbated by reductions in working time, growing non-wage labor costs, and the revaluation of the German currency. As a result, by 1997 western German manufacturing industry had the highest hourly labor costs among industrial countries, DM 47.92 (Schröder 1998). Part of this problem is that 45 percent of total labor costs stem from non-wage labor costs paid in addition to direct remuneration for hours worked, such as fringe benefit payments, six weeks of paid vacation a year, sick pay, and firms' obligatory social security contributions. Social security contributions are the single most important and dynamic cost factor, and their steady rise reflects severe problems for the German welfare state (see below).11

Germany enjoys a comparatively high labor productivity, but it is not always sufficient to fully offset the labor cost disadvantage, and the German system of collective bargaining and wage determination has come under attack in recent years. In light of increasing international competition and globalization, substantial transformation problems in post-communist eastern Germany, and growing unemployment, more and more employers (as well as economists, politicians, and journalists) are questioning the existing system and demanding more decentralized, company-related bargaining.

While collective bargaining at the sectoral level is conducted by unions, labor relations at the company level are heavily influenced by employees' codetermination rights and by works councils. In addition to employees' representation on supervisory boards of large companies, works councils may be set up in all establishments with at least five permanent employees. In practice, small firms are much less likely to have works councils than large ones, but around 60 percent of employees work in establishments with works councils (Addison et al. 1997). Works councils, elected for a four-year term of office, represent an establishment's entire work force, not just union members. Works councils are formally independent of the unions, but since about three out of four works councilors are union members, ties between both institutions are close. Works
councils can thus be regarded as “pillars of union security” (Müller-Jentsch 1995, p.61).

The law provides the works council with far-reaching rights of information and consultation (on issues ranging from manpower planning to changes in work processes, working environment, or job content) and with an explicit set of codetermination rights on social and personnel matters. Areas in which the works council has joint decision-making authority with management include: the commencement and termination of working hours, principles of remuneration, pay arrangements (including the fixing of job and bonus rates), the regulation of overtime and reduced working time, holiday arrangements, health and safety measures, and hiring and firing decisions. Works councils are excluded, however, from reaching agreement with the employer on wages and working conditions, which are normally settled by collective agreements between unions and employers’ associations at the sectoral level, unless the social partners explicitly authorize works agreements of this type. Nor does the law give works councils the right to strike, and it asks them to work together with the employer “in a spirit of mutual trust—for the good of the employees and of the establishment” (Müller-Jentsch 1995; Addison et al. 1996 and 1997).

Although works councils can restrict management authority, delay decision-making, and reduce company profits (Addison et al. 1996), employers have increasingly accepted works councils and their functions in the last 20 years. Managers frequently take advantage of the works councils’ authority over the work force to make them share responsibility for awkward personnel matters and strategic decisions (Jacobi et al. 1998). Mainly due to the challenges of globalization and technical change, this sort of cooperation at the plant level has gained in importance in recent years, with works councils often co-managing the restructuring of plants and processes (see below).

Social Policy and the Welfare State in Germany

Concerning the typical features of the German economy, corporatism is founded on relatively stable labor relations as well as corporate governance structures, and wage policy supports egalitarianism. While also contributing to egalitarianism, tax and social policy—understood in a broad sense—is the prime source of welfarism.

The German social market economy is based on the concept of social subsistence for the poor and for people who are unable to earn their own living and social security for everybody in old age and in
case of illness or unemployment. Moreover, the state redistributes incomes by means of a progressive tax system through social policy and other transfer mechanisms. Thus, in Germany, the government is much more responsible for attaining social objectives than in the United States, where philanthropic organizations, corporations, or individuals play an important role.

The expression "welfarism" appears justified, as social policy in the prosperous 1960s and early 1970s turned Germany into an expensive welfare state. Social benefits and insurance systems became more generous, job security provisions were raised, and the complexity of the subsidy and transfer system was increased considerably. This situation has hardly been reversed since the 1980s, as only minor reforms have been implemented.

Today, the German welfare state is under increasing pressure from several sides. Primarily, intensified locational and institutional competition limit the autonomy of national economic policy. Moreover, globalization and skill-biased technical change heighten the necessity for structural change and tend to contribute to labor saving if labor costs are too high and inflexible. Against this background, the welfare state has been increasingly criticized for obstructing structural change, impeding the creation of new jobs, and contributing to the persistence of unemployment. Several such channels can be identified.

First, increasing government and social expenditures put growing cost burdens on households and enterprises. The expansion of the state and social policy since the 1960s can be illustrated by the rising share of total government outlays and social expenditure in GDP (Table 1). While these measures increased, particularly during the early 1970s, reform efforts during the 1980s achieved a slight reduction. In the 1990s, the financial burden of German unification and a sharp rise in unemployment brought about new record levels of government and social expenditure.

<table>
<thead>
<tr>
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<th></th>
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<tr>
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<td>37.1</td>
<td>39.1</td>
<td>49.6</td>
<td>49.0</td>
<td>46.0</td>
<td>46.1</td>
<td>49.0</td>
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<tr>
<td>Outlays</td>
<td>21.7</td>
<td>23.2</td>
<td>26.0</td>
<td>33.4</td>
<td>32.2</td>
<td>31.4</td>
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<tr>
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<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

a. Figures for 1960 to 1990 refer to West Germany.

To finance the expensive welfare state, business and personal income taxation is high in Germany. In 1996, incorporated companies in western Germany faced total marginal tax rates of 65 percent on undistributed profits—the highest rate among industrial countries (Bröggemann and Fuest 1997). High personal income tax rates and rising social security contributions have also widened the tax wedge between total labor costs paid by employers and the net wage received by employees. This difference between labor costs for firms and consumption wage for workers is far greater in European countries than in the United States or Japan (OECD 1994).

The reduction of net wages resulting from a widening tax wedge impedes wage moderation, and labor demand falls when this tax wedge leads to an increase in total labor costs. The substantial growth of the tax wedge in the course of German unification has contributed to the rise in joblessness in the 1990s (Fehn 1997, p. 58).

Like a vicious circle, this increase in unemployment has led to a further rise in social security contributions and nonwage labor costs. This problem of the pay-as-you-go social security system is compounded by the increasing cost burden of an aging society. Intensified globalization and rising product market competition aggravate the negative impact of high business and labor costs on domestic employment. Greater capital mobility in a globalized economy facilitates investing abroad to evade high business costs in Germany. The incentive to move abroad is further raised as increasing product market competition makes it harder for enterprises to pass rising business costs on to consumers.

Second, the welfare state contributes to long-term unemployment via job-protection provisions such as dismissal restraints, long notice periods, severance payments, or restrictive regulations on fixed-term contracts. Germany’s job security legislation is considered generous by international standards (Nickell 1997; OECD 1999a).

When dismissals are costly, employers will be more cautious about hiring. Accordingly, empirical studies suggest that, although job-protection regulations may save jobs in the short term, they contribute to higher long-term unemployment (Nickell 1997; OECD 1999b). Furthermore, such job-protection measures and barriers to new hires enable “insiders” to achieve higher wages at the expense of marginal workers (“outsiders”). Thus, the well-intended job protection of workers has turned into a major disadvantage for the unemployed and, in this respect, the social market economy’s aim to support people in need appears to have been turned upside down.
Third, the German transfer system for people who are jobless or considered unable to work plays a role in the persistence of unemployment in Germany. This system’s generosity has increased over time, with only some minor reductions in the 1990s. Two kinds of transfers can be distinguished (OECD 1996a): Unemployment support consists of two subsequent schemes—unemployment benefits and unemployment assistance—currently amounting to between 67 percent and 53 percent of former standardized net income. Eligibility conditions are considered comparatively liberal.

Social assistance and other benefits (for example, child or housing benefits) are paid to everybody in need to guarantee a basic standard of living (Existenzminimum). While social assistance payments should by law remain below income from low-wage employment, this is not always the case, particularly not for married workers in low-wage jobs with two or more children. Both unemployment and social assistance are unlimited and means tested.

A relatively generous transfer system with high replacement rates can discourage recipients from taking work. In fact, empirical data suggest that exit from unemployment into employment is responsive to the benefit level and particularly to benefit duration (OECD 1996a; Layard et al. 1991). The incentive to search for work is further reduced in Germany because high marginal tax rates and benefit reductions discourage the transition from unemployment or social assistance into the labor market, leading to a poverty trap. As a result, most social assistance recipients who are able to work have little financial incentive to seek a job. By setting an implicit minimum wage floor, the benefit system also leads to high reservation wages, which implicitly narrow wage dispersion. All in all, generous income replacement conditions, though no immediate cause of joblessness, have contributed to the persistence of unemployment in Germany by lowering job search incentives (OECD 1996a; Bean 1994).

Summing up, Germany’s social market economy has lost sight of its original objectives. The transfer system has become increasingly complex and costly. It does not merely support the poor and people unable to work—many transfers or allowances, such as child benefits, are also granted to recipients with above average incomes. Neither does it provide social insurance only against life’s great risks—the health and pension insurance systems grant much more than a basic level of benefits. Furthermore, the welfare state protects
“insiders” in the labor market from competition from the unemployed, and the generous, unlimited assistance for the jobless has allowed a certain number of unemployed to earn their living from social transfers.

Several features of the welfare state limit the capacity for structural change brought about by globalization and technical progress. High business taxes and nonwage labor costs levied to finance governmental, particularly social, expenditures reduce the profitability of domestic investments, the vehicle for changing economic structures. Generous replacement rates—and the fact that unemployment transfers depend on former earnings—reduce the willingness of the unemployed to accept low-income jobs. As a result, people who lose well-paid industrial jobs are reluctant to resort to the employment opportunities in the lower paid parts of the service sector, which severely hampers structural change.

Until recently, the development of the tertiary sector was also hindered by legal barriers restricting entry into such markets as air transport, telecommunications, and postal services, which were governed by monopoly regulation. Restrictive regulations also drove out future-oriented biotechnology. Although most of these obstructions have been abolished in recent years, planning approvals are still lengthy and procedures complex. Shopping hours are still short by international comparison.

The German welfare state's reform needs can be put in a nutshell. Efforts to deregulate the labor and product markets should continue. Social security contributions must be lowered to bring down nonwage labor costs, and business taxes have to be reduced to make business investment in Germany more profitable. All in all, social policy must reduce its strong orientation toward redistribution and cradle-to-grave protection and concentrate instead on creating favorable conditions for economic and employment growth.

The Changing Relationship Between Shareholders and Stakeholders

In recent years, the influence of shareholders has gradually risen in Europe, including Germany, for several reasons. First, for larger firms, equity financing has gradually become more important relative to external financing through bank loans (Deutsche Bundesbank 1997). Increasingly, larger firms are also turning toward international capital markets for additional sources of financing as their capital
needs have grown in the process of internationalization. A considerable number of European firms have gained or seek entry to foreign stock exchanges. For example, the German firms Deutsche Telekom, Hoechst, VEBA, and SAP are listed at the New York Stock Exchange. Several German multinationals have also adopted more transparent accounting practices like the U.S. Generally Accepted Accounting Principles (for example, the former Daimler Benz, Deutsche Telekom, VEBA) or the International Accounting Standards (for example, Bayer, Deutsche Bank, Henkel, Hoechst).

Second, European capital markets have become more attractive to international investors, as financial opportunities have grown due to globalization, the abolition of capital controls in the European single market, progress in information and communication technology, and the advent of new financial products. Institutional investors have gained in importance on the European continent, especially in Germany (Blomme 1998). In Germany, the share of insurance companies and investment funds in domestic stockholdings has nearly doubled since 1990—though from a low level (Deutsche Bundesbank 1999a).

As a result of both developments, the shareholder-value ethos has also spread on the European continent. Today, the management of firms that rely heavily on international capital markets is being monitored much more closely, and demand for profitability and transparency is much stronger. This pressure comes mainly from institutional investors and rating agencies of Anglo-Saxon origin. Domestic shareholders’ associations—though still of little relevance—are slowly gaining importance in Europe (Schmitt et al. 1997, p.135). In fact, increased shareholder orientation is already apparent: major German joint stock companies not only publicly state their newly adopted shareholder-value orientation, but also the distribution of earnings to shareholders is gaining importance relative to the formation of internal reserves (Deutsche Bundesbank 1999b).

The closer focus on shareholders’ interests has limited both managerial scope and the power basis of stakeholders. For joint stock companies, increased demand for profitability reinforces the pressures from higher competition on product markets. Owner-led firms, of particular importance in Germany, feel these pressures from below, too. Both tendencies necessitate increases in companies’ efficiency. As in the United States, German and European enterprises of all sizes and legal forms have reacted to these challenges in different ways.
Internal reorganizations—signalled by such key words as “lean management,” “delaying,” and “profit centers”—have become common on the European continent. German companies have been giving more attention to product innovation (OECD 1996a) and, to raise profitability, have been concentrating increasingly on their core competence, on the activities in which they are specialized and most experienced. Historically, this can be regarded as a counter-movement to the diversification trend of the 1960s and 1970s. Another strategy is internationalization of production processes, mainly to expand in foreign markets but also to profit from lower business costs abroad. In the 1990s, German firms have immensely increased turnover and the number of employees in foreign subsidiaries, particularly in Eastern Europe and Asia (Härtel et al. 1996). Thus, “Made in Germany” is gradually becoming “Made According to German Standards.”

Concentrating on core competence also implies contracting out unrelated or underperforming production processes and services to raise profitability. Indeed, there is impressive evidence that German manufacturing industries, which particularly face international competition, have increasingly embarked on this strategy in the last two decades. An input-output model of the German economy shows that the manufacturing sector buys more intermediate goods and services from other sectors than it sells to them. This surplus, which can be regarded as a measure of the extent of outsourcing, has increased significantly over the last 20 years—from 0.7 percent of GDP in 1978 to more than 8.4 percent in 1996 (Gröning et al. 1998, p.96).

Jürgen Schrempp, Chief Executive Officer of the former Daimler Benz AG (now Daimler Chrysler), put the change in business strategies in a nutshell: “We concentrate on business fields in which we belong to the best—and we do that on a worldwide basis.” (Daimler Benz AG 1996, p.3). By implication, German multinationals pay less attention than they once did to patriotic sentiments when deciding about investing abroad or in Germany. The experiences of Daimler Benz and Hoechst AG give an idea of how immensely some German joint stock companies have changed in response to rising shareholder-value orientation.

Daimler Benz, Germany’s largest industrial company, completely reversed its strategy. After expanding into a highly diversified “integrated technology” concern, Daimler Benz shares were underperforming the stock market. In 1995, the company changed
its focus toward a distinctly articulated shareholder-value orientation, manifested, for example, in its stated objective of earning at least 12 percent on employed capital (Daimler Benz 1996, p.3). To streamline the company, many of its former acquisitions were sold off and management introduced multiple reforms, including a substantial structural reorganization to flatten hierarchies. In 1998, Daimler Benz merged with the U.S. car manufacturer Chrysler, which exemplifies the growing importance of mergers in the course of globalization and increasing international competition.

At Hoechst AG, a chemical concern whose history goes far back into the last century, the shareholder-value ethos has led to “one of the most drastic restructurings in Germany’s postwar corporate history” (Business Week 1997, p.14). To change the focus into the area of “life-science” (mainly health and nutrition), the concern has bought new companies, for example, in the field of biotechnology, and has pulled out of business lines that had belonged to the product range for decades. In 1999, Hoechst separated its “life science” activities from the industrial chemical business and merged the former with those of the French Rhône-Poulenc S.A. into a new company called Aventis.

Despite restructuring and streamlining, many German joint stock companies remain broadly focused in comparison to Hoechst. For example, the spectrum of the new DaimlerChrysler’s activities runs from traffic to transportation (ranging from road and railways to water, aviation, and aerospace) and to services. Veba, RWE, Mannesmann, and other German multinationals have expanded into telecommunications. Apparently, structural change toward services is taking place to some degree within existing firms. This feature matches the tendency described above toward persistence in German corporate structures.

All in all, the German manufacturing industry can look back on several years of thorough restructuring. In the 1990s, productivity in the western German manufacturing sector has risen by 3.4 percent annually, compared to 2.2 percent in the 1980s, or to 3.1 percent in 11 other industrial countries. Between 1993 and 1997, industrial productivity in western German manufacturing actually increased by 5.2 percent annually. Considerable wage moderation between 1990 and 1998 and a weaker deutschmark have further bolstered German international cost competitiveness. However, higher efficiency in the manufacturing sector has led to a substantial loss of industrial employment. Between 1990 and 1997, the number
of jobs in western German manufacturing has fallen by nearly 18 percent.

German banks also feel the growing orientation of joint stock companies toward the international financial markets and the increased importance of shareholders in German corporate governance. In fact, for larger companies (more than 50 million ECU turnover), the relevance of bank obligations has fallen slightly since the mid-1980s. However, for small and medium sized companies, the dominance of the Hausbank relation has largely continued (Sherman and Kaes 1997).

Concerning the role of banks as shareholders in supervisory boards or in exercising proxy voting rights, two main trends can be traced. First, bowing in part to public criticism, banks have stated that they will adopt a smaller role in corporate governance (Deutsch 1997). However, the tax and accounting system discourages a reduction in stockholdings of banks, as hidden reserves would be unveiled and taxed. Yet, the proportion of private bank representatives on supervisory boards has declined, mainly over the long term but also in recent years (Sherman and Kaes 1997). Second, legislative reforms have slightly restricted banks’ influence, for example, by prohibiting a bank from exercising a proxy voting right if its stake in the company exceeds 5 percent and if the shareholder has not given specific voting instructions. Since these alterations can be regarded as marginal, banks will retain their important role in German corporate governance in the near future.

As already depicted, the stock market has gradually gained in importance both in Germany and throughout Europe—both as a source of financing for companies and as a source of income for private and institutional investors. These trends will continue, because the introduction of the euro will broaden financial markets in Euroland as a result of increased transparency, reduced transaction costs and, above all, the abolition of the different national currencies. The equity market, in particular, should profit from EMU. Further privatizations and increasing private savings for old-age pensions will reinforce this tendency.

The relevance of the German capital market will be further raised by various reforms. To increase Germany’s attractiveness as a financial location, additional deregulatory measures have been implemented. For example, in 1998 the Third Financial Markets Promotion Law (Drittes Finanzmarktförderungsgesetz) liberalized derivatives and allowed for more flexible forms of investment funds. In addition, it facilitated the conversion of smaller firms into
joint stock companies and lowered the legal liability of financial
intermediaries when introducing a firm to the stock market. Other
legal measures (Gesetz zur Kontrolle und Transparenz im
Unternehmensbereich) have been taken to make the German stock
exchange more attractive to private investors:

- strengthening the effectiveness of corporate governance by
  increasing control requirements and legal responsibilities of
  the supervisory board
- increasing transparency with regard to German accounting
  practices, to cross-shareholdings, and to cumulations of
  supervisory board mandates on individual persons
- putting voting rights on an equal basis by abolishing multiple
  voting rights and voting caps.

Other reforms have also been undertaken to improve the
framework of the German venture capital market, particularly
through the Third Financial Markets Promotion Law (OECD 1998a,
p.138). In 1997, the New Market (Neuer Markt) was established, a
stock exchange for small and medium-sized technology-oriented
firms, where financial intermediaries other than banks are allowed
to introduce new companies. The New Market has been a great
success, opening up new growth opportunities for many companies
that would previously have been denied equity finance. During the
first two years, more than 100 joint stock companies have been
introduced, which represents a dynamic development for German
standards. Risk capital is also being supplied through a multitude
of public support programs. All in all, obtaining risk capital has
been and will continue to be significantly facilitated in Germany.
Nevertheless, the liquidity of Anglo-Saxon venture capital markets
can be expected to remain much greater, unless pension funds are
also introduced on a large scale in Germany.

Thus, the structure of German corporate governance as well as
the capital market framework are changing considerably.
Globalization and increased product market competition are
contributing to a shift of influence from stakeholders to shareholders,
and public policy is reacting to manifest shortcomings. However,
this does not imply that the German "insider" system will become
an Anglo-Saxon "outsider" system any time soon. For example, the
bias toward the formation of internal reserves, cross-shareholdings,
bank influence via various channels, and the two-tier board structure with codetermination requirements will continue to be important features of German corporate governance. Thus, the position of stakeholders in Germany will remain stronger than in Anglo-Saxon countries.

Changes in Labor Relations and Consequences for Employees

In the 1990s, the economic shock of German unification, increasing international competition and globalization as well as structural and technological change have posed new challenges not only for politics and business but also for trade unions and employers. In fact, the corporatist system of labor relations and collective bargaining shows some tendencies toward decentralization and erosion. A serious decline in membership and a corresponding reduction of influence on the side of both trade unions and employers' associations are contributing to this development.

Trade union membership, which had received a boost from unification, has subsequently fallen from 13.75 million in 1991 to 10.28 million in 1998. Today, fewer than 3 in 10 employees in Germany belong to a trade union. Traditional union strongholds are in public service and in manufacturing, but union recruitment efforts have not been successful in the growing private service sector, among white-collar employees, or among young employees. Unions thus have not been able to adjust their membership composition to structural and occupational change. For some unions, membership losses have caused severe financial difficulties, which have given rise to mergers and discussions on a far-reaching reorganization of the German labor movement. Despite these problems, unions' high density in strategic fields such as manufacturing means that they are still in a position to negotiate pace-setting collective agreements.

In recent years, employers' associations have come to face membership problems similar to those of trade unions. In most sectors, resignations from employers' associations, though not officially quantified, have been increasing. Also, more and more companies (in particular in eastern Germany) either do not comply with the terms of sectoral agreements or do not join an employers' association to avoid binding themselves into collective agreements, perceived as expensive straight-jackets. As a consequence, in some industries employers' associations have been founded which will
neither conclude, nor be bound by, industry-level collective agreements. Therefore, a growing number of employers as well as economists, politicians, and the media have demanded reforms of the German system of wage negotiations to achieve greater differentiation, flexibility, and plant orientation in collective bargaining policy, and thus to preserve jobs. These demands must be seen against the backdrop of the relentless rise in the unemployment rate to almost 10 percent in western and 18 percent in eastern Germany in 1997 since the unification boom ended in 1992.

A major problem of the current system of wage negotiations lies in the lack of interest in differentiated wage increases within trade unions and employers’ associations lest they undermine solidarity among their members. This has led to a “copying mentality,” which does not allow for differentiated negotiations among sectors and regions, despite formally independent sectoral trade unions and collective bargaining areas. Furthermore, since collective contract wages have increased so much, the scope has narrowed considerably for differentiation via “wage drift” (whereby plants pay premiums over and above the contract wage). Even if different industries have different wage agreements, the problem remains within each industry that sectoral collective agreements cannot take into account the particular situation of individual companies. In addition, collective agreements are criticized for trying to regulate too many details and limiting individual plants’ flexibility.

At first sight, one might argue that the goals of wage differentiation and employment security could better be reached through stronger orientation toward the individual situation of single companies (Berthold and Fehn 1996). A radical consequence of this insight and of the criticism regarding inflexible sectoral agreements would be to replace the existing system of sectoral collective bargaining with a system of company agreements between single employers and trade unions. In eastern and western Germany, about 5,400 companies independently negotiate wages and employment conditions with unions and usually do not belong to an employers’ association. Prominent examples are Volkswagen and Lufthansa.

According to the Federal Ministry of Labor and Social Affairs, the number of companies concluding company agreements has more than doubled since 1998, indicating a growing decentralization of collective bargaining in Germany, especially eastern Germany (Table 2). A recent empirical study for the private sector shows,
however, that 49 percent of establishments and 65 percent of employees in 1997 were still covered by industry-wide collective agreements in western Germany, whereas in eastern Germany the respective figures are just 26 percent and 44 percent (Bellmann et al. 1998). Newly founded firms and smaller establishments, which often feel insufficiently represented in the bargaining policy of employers’ associations, are less likely to be bound by industry-wide collective agreements, whereas big firms predominantly believe in the virtues of sectoral collective bargaining.

Table 2. Number of Companies with Company Agreements

<table>
<thead>
<tr>
<th>Year</th>
<th>Western Germany</th>
<th>Eastern Germany</th>
<th>Total</th>
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<tbody>
<tr>
<td>1990</td>
<td>2,100</td>
<td>450</td>
<td>2,550</td>
</tr>
<tr>
<td>1991</td>
<td>2,300</td>
<td>850</td>
<td>3,150</td>
</tr>
<tr>
<td>1992</td>
<td>2,422</td>
<td>1,178</td>
<td>3,600</td>
</tr>
<tr>
<td>1993</td>
<td>2,862</td>
<td>1,404</td>
<td>4,266</td>
</tr>
<tr>
<td>1994</td>
<td>2,889</td>
<td>1,445</td>
<td>4,334</td>
</tr>
<tr>
<td>1995</td>
<td>2,824</td>
<td>1,588</td>
<td>4,412</td>
</tr>
<tr>
<td>1996</td>
<td>3,081</td>
<td>1,632</td>
<td>4,713</td>
</tr>
<tr>
<td>1997</td>
<td>3,293</td>
<td>1,685</td>
<td>4,978</td>
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<tr>
<td>1998</td>
<td>3,606</td>
<td>1,765</td>
<td>5,371</td>
</tr>
</tbody>
</table>

Source: Federal Ministry of Labor and Social Affairs.

One major reason for the persistence of industry-wide contracts may be that, although bargaining on their own may be helpful for some companies, an overall strategy of dumping industry-level agreements also has disadvantages. Through industry-level negotiations, the relationship between management and works councils usually is only marginally affected by conflicts about wages and working conditions. When bargaining takes place at the plant level, however, industrial conflict is also transferred to this level, and strike frequency is likely to go up. This can weigh heavily on the plant’s work climate. When companies and work forces negotiate individually, they have to be aware that they cannot count on the solidarity of other employers and employees and that this can lead to undesirable results. There are already some signs that companies do not necessarily fare better under company agreements: wage costs at Volkswagen, for instance, are substantially higher than in the industry-level agreement for the metalworking industry. The “insiders” orientation of wage determination might even be strengthened by negotiations at the
plant level, where employees are more concerned about job security and wage increases than employment growth. In general, decentralized negotiations make it more difficult for both parties to control and moderate economywide wage trends whereas relatively centralized collective bargaining between comprehensive trade unions and employers’ associations can lower transaction costs and internalize the external effects of wage-setting.

Because of the various advantages and disadvantages and the virtual impossibility of identifying the best-working system, dumping the whole collective bargaining system does not seem sensible. Reforming the existing system to minimize its problems seems wiser. Trade unions and employers’ associations have reacted to mounting criticism in recent years by introducing certain elements of flexibility and decentralization into industry-level collective agreements, shifting bargaining competence to the company level. However, according to the German Works Constitution Act, the social partners at plant level (namely, management and the works council) are not usually allowed to conclude works agreements on collective bargaining issues because these are to be dealt with by trade unions and employers. The only exception is when the relevant trade union and employers’ association explicitly delegate issues to the plant level in their industry-level collective agreement through “opening clauses” that define the scope and limits of plant-level regulations (Schnabel 1998).

Opening clauses have been increasingly used in the area of working time since the mid-1980s. In exchange for the step-by-step reduction of weekly working hours (from 40.0 hours in 1984 to 37.4 hours in 1996 in western Germany), trade unions had to accept the introduction of opening clauses in most industry-level collective agreements. These allowed for plant-level negotiations on the distribution of working time to increase productivity by detaching individual working time from the establishment’s operating hours. As a result of such opening clauses, decisions on the beginning and end of the work day, working time fluctuations, overtime work, and the like are usually made by the social partners at the plant level. Over the years, this has resulted in an increasingly flexible use of working time at the plant level.

A new stage in this trend toward modernization and decentralization of collective bargaining was reached by recent, first-time agreements in several industries on opening clauses related
to wages and salaries. These opening clauses enable the social partners at plant level (management and works council) to conclude "works agreements" that deviate from the industry-level collective agreement within set limits. In most cases, however, the collective bargaining parties (trade union and employers' association) retain the right to veto such a works agreement.

In 1997, for instance, after several companies threatened to leave the employers' association, the social partners in the chemical and rubber industries in western Germany introduced an opening clause with veto rights in the national pay framework agreement (Schulten 1997). The opening clause allowed companies to reduce the collectively agreed wage by up to 10 percent for a limited time to save jobs, improve competitiveness, or both. In the same agreement, however, chemical firms that were doing well were asked to let their employees share in their profits. A similar opening clause in the eastern German construction industry agreement allowed for pay reductions of up to 10 percent. In the western German textiles and clothing industry, companies in economic difficulty were allowed to postpone collectively agreed wage increases in return for agreeing not to eliminate jobs, and companies with high profits were asked to share them with their employees. An opening clause without veto rights, in the printing industry in western and eastern Germany, allowed companies to postpone the payment of annual bonuses. Company management and works council may use all opening clauses only jointly, and neither party may use strikes or lockouts when negotiating a works agreement.

Different kinds of opening clauses concerning wages have been introduced in many industries in western and eastern Germany (Schnabel 1998). Through such opening clauses or—where there are none—by wildcat agreements with company management, employees have often tried to secure their jobs and prevent employment shifts abroad by making certain concessions that lower production costs. Several big companies (Mercedes Benz, Ford, Bayer, Opel) signed "employment alliances" with their work force. Typically, they contain a package of measures to boost competitiveness and preserve jobs through, for example, increased working time flexibility and limitations on pay increases in exchange for employment guarantees. The radiator manufacturer Viessmann promised its employees not to transfer the production of gas heaters to the Czech Republic and not to make employees in Germany redundant in exchange for an unpaid increase in weekly working time. The powerful metalworkers' union fiercely opposed this deal, which was not covered by an
opening clause, and the dispute was finally settled out of court by firm-specific modifications to the existing industry-level collective agreement. The prominent example of Viesmann shows that, in the face of globalization and mounting international competition, more and more companies are looking for ways to opt out of the collective bargaining system if they are not offered legal options for adjusting pay and working conditions to firm-specific needs, for example, via opening clauses.

The German system of labor relations is undergoing decentralization. This is apparent from the companies' proclivity to opt out of employers' associations and to conclude their own agreements with trade unions or (often illegally) with their workforce as well as from the opening clauses included in collective agreements, shifting decision-making powers to the management and works council at plant level. Although both trade unions and employers' associations have an obvious interest in retaining the centralized, corporatist collective bargaining system, they have slowly come to accept that they must give firms more freedom and flexibility to regulate working conditions at the company level. In consequence, the social partners in most industries have started to bring companies back into the legal framework of industry-level agreements by modernizing the collective bargaining system.

Within this system, the introduction of opening clauses means a substantial shift of regulatory authority from the sectoral to the plant level. By adjusting general, sectoral collective agreements to the specific situation in a plant, the plant-level parties and their relationship gain in importance. Conversely, the collective bargaining parties—the employers' associations and trade unions—lose some of their former power. The trade unions, in particular, have hesitated to decentralize labor relations for fear of losing influence to the formally independent company works councils. Although works councils are made up mainly of union members, their behavior is often much more pragmatic and flexible than that of the more political and ideological trade unions.

In addition to these developments in working time and pay determination, since the mid-1980s several managerial measures have also led to a decentralization of labor relations and to increasing importance for the plant level. Measures such as the introduction of new technologies and organizational settings (in particular, through "lean production" and "re-engineering") came about as a result of worldwide technological and structural changes and increased
international competition (Weins 1992). As in several other countries, many German firms have introduced new forms of employee involvement such as quality circles and teamwork as part of a "human resource management" policy (Jacobi et al. 1998). Estimates suggest that quality circles have expanded to the point where most large companies have them, aiming for total quality management. The restructuring of production and work organization, stimulated by the large productivity lead of Japanese and U.S. car producers, has resulted in the widespread introduction of teamwork in the German automobile industry, but teamwork has spilled over to other industries in recent years.

These new elements of direct participation are intended to complement, not displace, Germany's institutionalized employee representation via works councils. In contrast to the labor relations scene in Anglo-Saxon countries, in Germany collective relations cannot be circumvented by human resource management strategies that concentrate on individual relations. Because of the guaranteed co-determination rights of works council, such personnel policies usually do not have an anticollective tendency in Germany. A recent study of the chemical industry shows that, while human resource management has a stronger influence on individual- than on collective-level labor relations, it seems to stabilize the traditional, collective-level relations within the company via works councils instead of destabilizing it (Fischer and Weißbrecht 1995).

Also due to the shift of authority from sectoral bargaining to the company level, works councils can now be regarded as "the pivotal institution of the German industrial relations system, their position vis-à-vis the union having been continually strengthened" (Müller-Jentsch 1995, p.55). Managers have increasingly accepted works councils and their functions, and they often try to take advantage of the confidence works councils command in the workforce by asking them to share responsibility not only for awkward personnel matters but also for certain strategic decisions. When a company goes through economic difficulties, many works councils today support management policies for modernizing and rationalizing production that are likely to improve the firm's potential for economic survival. Often, works councils actively cooperate with the kind of human resource management that usually accompanies comprehensive restructuring of production, and this cooperation has extended to the unavoidable downsizing of many firms.

Against the background of increasing international competition and globalization and during the severe recession of 1992–93, firms
in western Germany had to resort to more layoffs, restructuring, outsourcing, and other unpopular measures than in the past. The objective of this corporate downsizing strategy was not simply to cope temporarily with shrinking demand, but permanently to cut costs, boost productivity, and increase competitiveness. Another reaction of German firms to high and rising domestic labor costs has been to shift production—mainly to the United States and to other western European locations, but also to post-communist countries in central and eastern Europe, where labor costs are considerably lower. In 1997, in manufacturing, for example, ten Czech or Hungarian or nine Polish workers could be employed for the price of one western German worker (Schröder 1999). Although productivity gaps in the post-communist countries are substantial, western firms, transferring their know-how and organization, can often narrow them. For German firms, Poland and the Czech Republic in particular have become low-wage labor pools with a relatively skilled workforce, geographically close enough to Germany to be included even in just-in-time production.

As a consequence, employment in large companies has generally fallen within Germany in the 1990s. At the same time, the employment figures of these firms outside Germany have risen, and profits are increasingly made abroad. Moving activities to cheaper locations abroad, selling off noncore businesses, and reorienting the company to the stock market with shareholder-friendly policies has led to accusations that corporate Germany no longer fulfills its share of the implicit social contract. However, by shifting production of labor-intensive primary and intermediate goods to lower cost foreign locations, German firms can improve their cost structure and may thus preserve jobs at home in the long run.

In light of these developments and high unemployment, the trade unions adopted a more moderate, employment-oriented wage policy, which has helped to improve German companies’ international competitiveness and preserve jobs. The moderate wage increases agreed in 1996, 1997, and 1998 reflect the social partners’ willingness to tackle Germany’s massive labor-cost and employment problems and to preserve the traditional system of industry-level collective bargaining, if in a modernized form. Some industries have also concluded collective agreements that allow companies to pay employees newly hired from among the long-term unemployed only 90 percent of the collectively agreed wage rate. Most trade unions, however, are still reluctant to address the problems of low-
skilled workers who fall victim to skill-biased technical change and high collectively agreed minimum wages. Lowering their wages would increase wage dispersion in Germany, which is one of the lowest among industrial countries (OECD 1996b, ch.3). Combined with necessary reforms in the German tax-transfer system, however, it could improve these workers' employment prospects. It would also be a crucial step toward exploiting neglected employment opportunities in the service sector (Klöß 1997).

Reform of the Welfare State

Globalization, increasing international competition, and technical progress have put pressures on the traditional German welfare state. Despite several supply-side reform initiatives in various fields, the balance sheet of reform shows a mixed picture. As mentioned, legislative changes are intended to broaden Germany's financial market. Former monopolies such as telecommunications, postal services, and air transport have been privatized and deregulated. In a new reform effort started in 1996, the federal government reduced business taxes, lowered statutory sick pay, facilitated dismissals, and extended shop-opening hours. A substantial reform of the pension system was begun to limit the effect of population aging on social security contributions, a major part of nonwage labor costs. All in all, multiple but mostly minor reforms have been effected. Some further plans of the former conservative-liberal government such as a far-reaching income tax reform were halted by the second parliamentary chamber (Bundestag) where the social democratic-governed federal states (Länder) had a majority.

In contrast, the new coalition government of Social Democrats and Greens, formed in fall 1998, has set out on a more demand-side oriented course of economic policy. Several supply-side oriented reforms of the former government have been reversed or postponed, including alterations in job security regulation and in the pension system. The federal government is going to implement a less extensive income tax reform, with the primary objective of reducing the tax burden on low-income groups. Among a variety of other initiatives, an "ecological tax reform" has been introduced whose revenues are used to lower social security contributions, and a business tax reform has been envisaged. In summer 1999, however, budget problems forced the government to announce a fiscal consolidation package containing substantial austerity measures.
Many other European countries face problems with the welfare state similar to those in Germany. In dealing with these problems several other left or center-left governments in Europe have successfully begun or continued supply-side-oriented reforms. While the approach and experience differ from country to country, some common trends stand out. Germany, Denmark, and the Netherlands are often regarded as typical countries where corporatism, wellfamilism, and egalitarianism have been particularly pronounced. 39

Throughout continental Europe, a tendency can be detected toward reducing the generosity of social policy. As a very broad measure, the share of total government outlays in GDP has been lowered in most continental European countries, particularly since 1993. In Germany, this ratio has increased considerably in the 1990s, mainly due to financial transfers related to unification, and was recently lowered but only marginally. Though retaining a high level of government spending, the Netherlands and Denmark have made substantial and decisive cuts in public budgets.

Job protection regulations differ among the countries in focus. In contrast to Denmark, where job security provisions are practically nonexistent, they have remained strict in Germany and the Netherlands. While in both countries regulations on fixed-term contracts and temporary-work agencies have been relaxed, “insiders” remain well protected because marginal groups and new entrants largely shoulder the burden of this new kind of labor market flexibility. The increase in temporary work is especially pronounced in the Netherlands.

With regard to unemployment and social benefit programs, most countries in continental Europe have made only minor changes in benefit level and duration. While this is true for Germany, Denmark shortened the maximum duration of unemployment benefits from nine years to five, and the Netherlands froze social assistance in nominal terms for some years. However, the generosity of benefit programs remains high in all three countries, particularly when compared to the United States and the United Kingdom.

More effort has been made to tighten regulations governing welfare benefits such as eligibility conditions or availability and willingness-to-work requirements. The Netherlands and Denmark, for example, increasingly sanction the refusal to take up an offered job or training program by reducing or terminating benefits. In Germany, such sanctions are also possible but usually not strictly
enforced. For example, few German municipalities use their legal discretion to oblige applicants for social assistance to accept work in public or subsidized work programs.

The Netherlands and Denmark also apply strict measures and sanctions to integrate marginal groups such as young people, the long-term unemployed, and the low-skilled into the labor market. Both countries offer a wide variety of public or subsidized jobs as well as training and education programs and make their acceptance obligatory. These initiatives are intended primarily to bridge the way into regular employment and to raise participants' qualifications to prepare them to get a job in a labor market characterized by relatively high minimum wages. Thus, financial support is used to subsidize work instead of inactivism, and society is to a certain degree repaid for financing these programs, which often involve socially useful jobs. However, any public job program carries with it the risk of crowding out employment from the primary labor market.

Employment opportunities for the long-term unemployed and the low-skilled can also be enhanced by reducing labor costs or regulatory restrictions. For this purpose, the Netherlands uses lower social security contributions and tax reductions. Germany offers certain wage subsidies and has, for example, created integration programs mainly for the long-term unemployed (Eingliederungsvertrag), stipulating, among other things, that dismissals can be effected immediately and that the state takes the financial risk of absenteeism. So far, however, employers have used these programs only to a very limited degree. In contrast to many Anglo-Saxon countries, the strategy of improving employment opportunities for the low-skilled by supplementing incomes earned in a low-wage sector by means of employment-conditional benefits is rarely applied in continental Europe, where income-support policy is implemented mostly in the form of legal or bargained minimum wages.

Summing up, the countries in continental Europe are reforming their welfare states with different intensities. As prominent examples, especially the Netherlands but also Denmark have followed a course of supply-side reforms to reduce unemployment and to strengthen their international competitiveness. With lower unemployment, keeping a high level of social welfare is less financially burdensome and causes smaller labor market distortions. To bring many inactive benefit recipients back into the labor market, regulatory
strictness counters low-skilled workers' limited incentives to work in a welfare system with high replacement rates. Thus, solidarity has been reinterpreted to make marginal groups earn their own living as far as possible, instead of relying on passive income support.

Taking a broader look at welfare state reforms in continental Europe, a principal difference among European nations becomes obvious: generally, smaller countries, such as the Netherlands, Denmark, or Ireland, have made more progress than larger countries such as Germany and France, which seem to be less ready for thorough social policy reforms. This feature can be put into the context of increasing globalization. The smaller countries were in deep economic crisis at the onset of their reform course. These crises may be related to the greater openness of smaller countries to international trade, which means that they were confronted much earlier with pressures from rising international competition. While in Germany and France unemployment rates are now at record levels, economic crisis does not yet appear so deep as to impel wide-ranging reforms.

In the Netherlands, however, a serious loss of competitiveness and high unemployment led to the milestone Wassenaar agreement between the social partners in 1982, which initiated the comparatively slow but steady supply-side reforms followed thereafter. While the basic pillars of the welfare state have been kept intact, social policy reforms in the 1990s aimed at strengthening market forces and integrating marginal groups into the labor market. Apart from the reforms mentioned above, important elements of this agenda have been:

- supporting international competitiveness, especially by long-term wage moderation, and an alignment of the guilder to the deutschmark
- considerable consolidation efforts in fiscal policy resulting in a significant reduction of the tax wedge in the 1990s
- moving toward more flexible working arrangements with a particular focus on part-time employment
- privatization and deregulation in product markets.

Since these reforms, the Netherlands has entered a "virtuous circle of strong international competitiveness, high profitability, buoyant investment, and rapid job creation" (OECD 1998b, p.4).22
Upon taking a closer look, however, some qualifications are in order. The share of long-term unemployment stands at nearly 50 percent and has only recently declined somewhat. Moreover, due to formerly generous disability and early retirement programs, broad unemployment amounts to 25 percent, and participation in the labor market remains low compared to other European countries. However, inactivism of this sort has fallen recently. Despite these qualifications, particularly in recent years Dutch employment has outperformed that of the European Union as a whole. In view of its successful course of reform, the Netherlands appears to show "how capitalism can work with a friendly face as well" (van der Ploeg 1998). Only the Netherlands is discussed here, because it is regarded as a reform model from the German point of view. In Denmark the course of reform has been less thorough and results have been moderately positive.

While the effectiveness of the Dutch (and Danish) reform approaches still has to be proved in the long term, Germany might learn some useful lessons, particularly from the Netherlands. Elements that could be copied, despite the undoubtedly differences between the countries, might be, for example, long-lasting wage moderation, more flexible working time, stronger fiscal consolidation, and stricter enforcement of sanctions in benefit programs. However, the social consensus needed to implement such reforms, which would significantly affect core groups of society, has not yet been achieved in Germany. Thus, it remains questionable whether Germany will, in the near future, follow the Netherlands and other continental European countries on the course of substantial welfare state reform.

Conclusions
The German social market economy has proved quite stable and relatively successful in the last 50 years, but the challenges of globalization, technical change, and shareholder-value orientation are forcing it to change, to become more flexible. These pressures are compounded by German unification. Although attempting to maintain corporatist stability while at the same time increasing corporate flexibility may sound like squaring the circle, the federal government and the social partners have slowly started to modernize the present system. Formal and informal reforms are under way in several fields, ranging from corporate governance over labor relations
to social policy, and a new balance between the demands of shareholders and stakeholders needs to be found.

Concerning corporate governance and capital markets, globalization and increasing international competition have shifted some power from stakeholders to shareholders and have prompted a reorganization of many corporations as well as financial market reforms in Germany. This does not mean, however, that the German "insider" system of corporate governance will soon become an Anglo-Saxon "outsider" system. While acceptance of Anglo-Saxon standards is growing, basic institutional differences between both systems remain, and in the foreseeable future the position of stakeholders will be considerably stronger in Germany than in Anglo-Saxon countries.

Correspondingly, Germany's corporatist system of labor relations and collective bargaining shows some tendencies toward decentralization and erosion, but no inclination to adopt Anglo-Saxon labor relations. While several European countries have shifted some bargaining authority to the plant level, this sort of controlled decentralization (visible, for instance, in the Netherlands and Germany) does not mean that cooperation between the social partners at the sectoral or national level has been completely abandoned. At the plant level, in contrast to the United States, human resource management strategies complement rather than replace traditional personnel policies because guaranteed codetermination rights have to be taken into account. Codetermination via works councils and labor representatives on supervisory boards also means that, while shareholders' influence is definitely rising, stakeholders continue to play an important role in German corporations.

In Germany and other countries in continental Europe, the costly welfare state has come under increasing pressure because it raises labor costs, inhibits structural change, and contributes to unemployment persistence. The concept of guaranteeing high wages and job security for core groups of "insiders," who have to finance an ever-increasing volume of transfers to continually rising numbers of unemployed "outsiders" and other benefit recipients, has become less and less sustainable. Therefore, several European countries have tried to reduce the generosity of social policy, benefit programs, and job protection while maintaining a social security net that is still much stronger than in the United States. In this respect, however, Germany has not changed much because many Germans
clinging to the idea of a generous, enveloping welfare state and because its institutional settings allow too many groups to block reforms.

While in some aspects discussed above, continental Europe seems to be moving in the direction of the Anglo-Saxon countries, full convergence is not likely, due to differences in cultures and mentalities. This need not be a problem because the experiments under way in welfare states like the Netherlands and Denmark seem to indicate that “Rhine Capitalism,” with its emphasis on social security and consensus, can be sustained if substantial reforms are implemented and a new balance is struck between equity and efficiency. Nevertheless, even for continental European countries, the Anglo-Saxon model provides a helpful benchmark. Competition among political systems and economic institutions helps to identify the most effective ways to tackle the severe structural problems common to all industrial countries.

To meet the challenges of globalization and reforming the social market economy, two different sorts of experience may simultaneously serve as points of orientation. On one hand, Germany should try to learn from best practices abroad, including the Anglo-Saxon countries. On the other, the social market economy should recall its own strengths and return to its roots: basic principles such as subsidiarity, decentralization, and the prevalence of individual responsibility over collective regulation must be invigorated. The welfare state should serve only as a last resort to provide shelter from the greater risks of life. Since globalization restricts the possibilities for corporatist intervention in the economy, it should not be seen primarily as a threat to the social market economy but rather as a chance to implement reforms that are overdue and which will raise social welfare in the long run.
Notes

1 For a detailed analysis of the “fading miracle” see Giersch et al. (1992).

2 “A stakeholder is any nonstockholder whose welfare is tied with a company—such as a creditor, employee, customer, supplier, or member of the company’s host community,” (Kemmis/Martin 1992).

3 According to the Deutsche Bundesbank (1997), banks hold about 10 percent of all shares in circulation in Germany—a significantly higher share than in the United States (0.2 percent) or the United Kingdom (2.3 percent). Some bigger banks hold larger blocs of shares of various firms among the 100 largest companies in Germany (for more details see Monopolkommission 1998).

4 The influence of banks has been widely criticized in recent years, particularly the lack of transparency in share-ownership of banks, the exercise of share and proxy voting rights, and the personal concentration of supervisory mandates (see for example, Sherman/Kaun 1997; Monopolkommission 1998). However, single banks generally do not wield majority voting power and are considered to exercise important surveillance functions.

5 For a graphic illustration of the network of stock ownership and cross-shareholdings including banks and insurance companies see Monopolkommission (1998, p.81).

6 This issue has recently attracted considerable public attention and criticism. Among the most prominent studies see Monopolkommission (1998) and Bundesministerium für Wirtschaft, Gutachten des Wissenschaftlichen Beirats (1997).

7 After the introduction of the small joint stock company in 1994, more than 400 firms chose this legal form in the two following years (Monopolkommission 1998, p.30).

8 In the past, various features of the taxation system exerted a bias against choosing the legal form of a joint stock company such as a double taxation of the firm’s and the investors’ earnings until 1977 and a double property taxation until the end of 1996 (for more detail see Feix 1980; Deutsche Bundesbank 1997).

9 Management and important members of the supervisory board share a common interest in the formation of retentions of profits, based on the reasoning that larger reserves provide more security in case of a crisis. When the build-up of reserves does not reduce profitability too much, this practice meets the demands of the management not to be dismissed immediately, of suppliers and customers for stable relationships, of banks for the repayment of loans, and also of employees for job security.
More than anything else, it is the German system of centralized and interconnected collective bargaining that is responsible for the low dispersion of wages in Germany between individuals, industrial sectors, and small and large firms. (Ostwick 1997, p.243).

Traditionally in Germany, the costs of social security are equally shared between firms and employees, and social security contributions are paid in the form of deductions from wages. Whereas in 1970 the overall contribution to social security funds in West Germany amounted to 28.5 percent of eligible gross earnings, by 1998 this percentage had risen to 42.4, or 21.2 percent of gross wages for firms and employees each. Ranked in descending order of contribution rates, the more or less compulsory social security system consists of a pay-as-you-go pension insurance (20.3 percent of gross wages), health insurance (13.9 percent), unemployment insurance (6.5 percent), and long-term care insurance (1.7 percent).

For a brief description of dismissal procedures in Germany see Kraft (1997).

A comparison of the British, U.S., and German welfare systems shows that the German system is characterized by high benefits and low work incentives (Peter 1998).

Empirical findings lend some support to the implicit conjecture that reduced profits, market valuations, and stock returns have resulted from integrating businesses of different industries (Servies 1996).

Empirical analyses generally have not been able to identify robust relationships between the level of collective bargaining and various measures of economic performance (OECD 1997a, ch.3). The thorough theoretical analysis by Moene et al. (1995, p.120) concludes that "[i]n the presence of strong, cohesive unions, a mixed system of centralized bargaining over the base wage and subsequent firm-level bargaining under a peace clause may be the best compromise between divergent concerns."

Some industry-level collective agreements pay special attention to the often more difficult economic situation of small enterprises by allowing those companies to reduce wages below the collectively agreed level without any veto by trade unions or employers' associations. In eastern German retail trade, for instance, companies with up to 15 employees may pay 9 percent, and companies with up to 5 employees 8 percent, less than the collectively agreed wage rate.

In a case study of 55 firms, Kotthoff (1994) traces a sea change in management attitudes: whereas in 1975 two out of three works councils were adjudged to have an ineffective machinery, by 1990 two-thirds of the sample engaged in constructive dialogue with management.

In general, works councils try to protect the interests and jobs of employed "insiders," but in bad times they often seem more willing to accept layoffs (which mainly affect peripheral workers) than pay cuts (which would offer employment opportunities for unemployed "outsiders").

20 A similar concept has also been adopted in the United Kingdom.

21 In contrast to Germany, most reform steps were supported by a broad consensus among the Dutch people even though core groups of society ("insiders") were also affected (OECD 1997d, p.14).

22 The Dutch unemployment rate has fallen from 11 percent in 1983 to a little more than 4 percent in 1998. However, due to a rapid expansion of part-time work, employment measured in full-time equivalents has grown less than the number of jobs.

23 This measure includes inactive people of working age in unemployment, social assistance, early retirement, or disability programs and is related to a broad labor force that also includes these groups (OECD 1998b, p.33).
References


V. Globalization, Competition, and the Corporation: The U.K. Experience

Mark Casson and Philip Mc Cann

The concept of globalization can be considered from a variety of different perspectives, with the principal ones being economic, political, technological, and cultural. In each globalization paradigm, sets of common influences are assumed to act more or less simultaneously upon different groups in different geographical parts of the globe. In some cases, these influences will produce similar outcomes; in other cases, the outcomes may be quite different. The variety of outcomes will depend on exactly how the common influences were mediated in each area and how local interested groups responded to and acted upon these common global influences. To understand the relationship between these global influences and the sets of local outcomes, we have to decide which paradigm we wish to adopt. Our choice will depend mainly on the particular features of globalization on which we wish to focus. Although these analytical perspectives are distinct, they are not necessarily mutually exclusive in terms of either their influences or outcomes. Moreover, adopting one perspective as our principal analytical approach does not rule out incorporating these other perspectives within our analytical framework.

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Here, we are interested mainly in the economic features of globalization. We focus on the relationship between globalization, the behavior of industrial enterprises, and the corporate and institutional responses to governance in the United Kingdom. How globalization comes about will in part determine the nature of this relationship. In economic terms, globalization may arise through the expansion of trading networks, through improvements in communications infrastructure, through the imitation of various foreign industrial practices, or through increases in cross-border flows of foreign direct investment (FDI). However, within any country, labor relations and institutional economic behavior in general are a product of both the current competitive environment and the competitive history of the country.

The U.K. Context
The British economy was the first modern industrial system. During the nineteenth century, Britain's economy was the workshop of the world, and British output across all sectors accounted for approximately one third of global output (Cameron 1993).

The Production Sector
The raw materials required for this productive effort originated primarily in the colonial parts of the British Empire—Canada, Australia, India, and many parts of Africa. This resulted in a two-way flow of trade between Britain and its colonies, with Britain importing raw materials and exporting finished and semifinished goods. The initial development of this global trading system exhibited three key interrelated but distinct features, without which the growth of this system would have been impossible. These features were rapid technological change, the development of sophisticated forms of financial instruments, and the expansion of market areas.

The industrial revolution of the eighteenth century heralded an era of significant technological progress in which production innovations arose from both the employment of new forms of machinery and the increased specialization of labor activities. Modern commentators frequently discuss these features of economic growth from the rather narrow technical perspective of Adam Smith's observations of labor organization within the firm. However, these developments were taking place within a much larger context, which included the growth of input and output market areas (North 1981). This market area growth was necessary to provide
both the input raw material required for the production process and an enlarged market for British industry’s increased output. However, the expansion of these market areas itself also encouraged the development of more sophisticated financial instruments, which provided the debt and insurance capital required to facilitate colonial expansion by both individuals and trading companies. Early in the internationalization of the British economy, the London merchant banking sector had therefore played a key role in the development of global markets. Yet, the role of this sector in domestic industrial finance was more limited, with a large share of domestic capital investment still financed by internally generated profits.

Historically, the U.K. economy has performed a particular role as the major link between the U.S. economy and the economies of Europe. Against a background of common linguistic, cultural, and historical ties, the establishment of strong and stable economic ties between Britain and the United States has been brought about both by increased mutual trading linkages and by major flows of FDI between the two countries. The close economic integration engendered by these two-way flows of FDI has meant that each country has traditionally acted as an incubator for the industrial innovations developed in the other country. At the same time, the colonial history of Britain ensures that the influence of its domestic concerns also radiates over a wider sphere than the North Atlantic axis.

During the nineteenth century, Britain was the world’s largest exporter of FDI capital (Jones 1996). For most of the century, the pattern of trade between the United States and Britain largely reflected the global trading patterns internal to the British colonial system. Raw material imports to the United Kingdom such as cotton were exchanged for industrial exports to the United States. As the U.S. economy grew, however, its trading relationships with Britain began to change (North 1966). By mid-century, many of the technical and financial innovations of the British industrial revolution had been imported into the United States. These imports took place both by the straightforward imitation of British innovations in such areas as accounting practices and stock exchanges (Kaplan and Johnson 1987) and by the direct implementation of British techniques and industrial practices via British foreign direct investment in the United States.

The American adoption and adaptation of many of these British industrial innovations was initially concentrated primarily in the northeastern states, and the resulting productive capacity in no
small measure contributed to the eventual outcome of the U.S. Civil War. Yet American industry was also beginning to exhibit its own distinct character, based on a series of domestic industrial innovations. Following the Crystal Palace exhibition of 1851, the system of manufacturing arms on the basis of standardized interchangeable parts was the first American production innovation with a major influence in Britain (Best 1990, 1998). The subsequent civil war economy, which required large-scale munitions production, not only encouraged the widespread adoption of these principles within U.S. industry but also led to many further technical innovations within American industry. The two-way flow of ideas and innovations between British and American industry increased during the middle years of the nineteenth century. However, British industry, which was based primarily on craft-based principles of production in which workers were paid according to skill instead of the nature of the activity, would progressively become the imitator of American innovations during the second half of the nineteenth and early twentieth century. As a result, the flow of ideas and industrial innovations became more unilateral than bilateral, with Britain adopting and adapting American innovations within its own industrial context.

The American principle of standardized production based on interchangeable parts required a change in labor practices, from the employment of traditional craftsmen to ones based on specialization, precision working, and measurement. During the following decades, however, the changes in production techniques and labor practices went much farther. The second major industrial innovation was the development of flow-line principles of production, in which groups of machines were laid out according to the order of the machining activity required instead of according to function. This innovation, which reduced internal inventory handling and transport costs, required inventory flows to be balanced at all points in the production process. This principle afforded major economies of time by increasing the speed of production throughput. However, genuine mass production only came about with the advent of the continuous flow principle, in which no two products were ever at the same stage of production on a single production line (Best 1990, 1998).

These ideas originated in the U.S. refining, distilling, and tobacco industries, but their worldwide impact on production organization arose primarily due to their application in metalworking industries, which dominated goods production in the early twentieth century. The automotive manufacturer Ford first developed the
automated production line, in which the continuous flow of materials was ensured by a conveyor belt. Soon other U.S. industries adapted these ideas to their production, and the assembly line became the standard production model for many industries.

Central to this system was the need for managerial coordination to ensure the smooth running of internal operations. This is because the whole system was vulnerable to individual breaks in the chain of activities. The required coordination of these large-scale activities therefore contributed to the third major industrial innovation with U.S. origins, namely the development of a large managerial hierarchy. This developed both as a response to the technical economies of scale afforded by increasing firm size in sectors such as railroads (Chandler 1977) and automobiles, and also as a means of establishing market control over production factors and inputs, particularly in sectors such as oil and steel (Livingston 1987). The principle of managerial control extended well beyond merely coordinating activities within the plant to include the control of the flow of inputs into the plant, and wherever possible, to integrate production, inventory, and marketing operations. The internal integration of all these activities was intended to ensure a stable market environment for a firm's inputs and outputs and to exclude any other external influences.

In the late nineteenth century and early twentieth century, the absence of capital flow restrictions and the adoption of the gold standard contributed to the acceleration in the level of global FDI flows (Jones 1996). At the same time, the growing success of American industry led to much imitation on the part of Britain, as well as the newly industrializing European economies of France, Germany, and Italy, and also that of Japan. The three American firm innovations of standardized production, flow-line principles, and the managerial hierarchy, which eventually culminated in mass production techniques, were widely imitated, as were many features of the American regulatory institutions, such as the antitrust agencies.

Although these economies came to resemble the U.S. model to a large extent, they were not able to completely imitate the American system. Part of the reason is that, unlike the U.S. economy, these economies relied fundamentally on world markets for inputs. At the same time, in these other economies, the explicit role of the state involved protecting certain domestic industrial interests and sponsoring preferred industrial alliances such as the U.K. creation of ICI from the Brunner-Mond-United Alkali merger after World
War I. To some extent, this intervention was a response to the perceived need for self-sufficiency, particularly within the military-industrial sphere. In each of these countries, the state also played a key role in shaping corporate relations and behavior, although the resulting relations in each country were also a product of its own history.

Through the internal integration of all activities within the managerial hierarchy, American firms excluded any external influences that might cause instability in its productive environment such as from financial markets or government. This meant that, in the mass production sectors from the turn of the century onward, U.S. corporate expansion into international markets generally took place via internal funding arrangements and without any government assistance. Apart from corporate culture, however, this was also because national governments were simply too small relative to the major U.S. corporations to exert any meaningful influence over them. Although the mass production economies that later developed in other countries were ostensibly imitations of the U.S. economy, their organization and functioning were often quite different, in that both banks and in some cases governments played key roles in the development of inter-firm relations (Piore and Sabel 1984).

During the nineteenth century, British industry had developed primarily as a system of family-owned firms, in which the family ownership system largely protected the British firms from the vagaries of the financial markets. Some of these firms, such as Cadbury in Birmingham, Joseph Rowntree in York, and Lever Brothers in Port Sunlight, had also developed their own characteristic form of industrial paternalism, which provided for the housing and schooling of the workforce. This form of corporate philanthropy can be viewed largely as a labor-governance mechanism, which excludes the influence of trade unions and therefore protects the holding family's interests. Although these models were highly successful, they never became the standard model of U.K. industrial and labor market organization.

The political instability and industrial unrest of the early twentieth century led to growing militancy on the part of the craft-based trade unions (Phelps-Brown 1983). Widespread labor organization and industrial action meant that the standard model for U.K. labor governance became a confrontational bargaining system, in which corporate revenues were used to buy off union militancy. Government played no role in this process. The resulting union-management bilateral monopoly relationship became the
standard corporate governance model for British industry until the 1980s, and it was into this context that the U.S. mass-producers first entered.

In Britain, as we have seen, the imitation of American industrial innovations had started in the mid-nineteenth century, resulting in a bilateral process of technology transfer. This process continued both during the following decades of worldwide FDI expansion and during the period of worldwide FDI contraction in the 1930s depression years. By the interwar years of the twentieth century, however, the emergence of the United States as the world’s leading economy implied that the flow of technology transfer had become more unidirectional, with U.K. industry successively imitating U.S. innovations.

Like the U.S. importation of British industrial innovations during the nineteenth century, British industry’s imitation of U.S. innovations took place via two distinct means. The first was the copying by British firms wherever possible of the characteristic features of the American model of industrial organization, as had been the case for small arms manufacturing in the nineteenth century. The second and more direct method of technology transfer was the introduction of U.S. industrial characteristics into Britain by immigrant American firms. U.S. multinational firms adopted a variety of FDI strategies of investment, from mergers and acquisitions to direct “greenfield” investments. The relative importance of this second mode of technology transfer increased enormously with the huge expansion of U.S.-owned subsidiaries into the United Kingdom during the interwar years. In particular, the real spur to this process came about with the large-scale entrance of U.S. mass-producers into the U.K. market, primarily through foreign direct investment. This expansion was initially spearheaded by the U.S. automobile firms but was closely followed by U.S. consumer goods producers in many manufacturing, food processing, and pharmaceuticals sectors (Dunning 1998). The domestic presence of these firms, their demands on their suppliers, and their effects on U.K. domestic market competition all led to further imitation by U.K.-owned firms.

Not all firms in all U.K. sectors could adapt to the new competitive environment. In terms of labor market effects, in mass production systems, corporate profits within the expanding markets depended primarily on the implementation of technical production innovations without any requirement for labor training beyond the necessary
repetitive tasks. The success of this mass production model, therefore, depended in part on the existence of a malleable labor force, willing to operate the machines at full capacity and to accede to the application of the Taylorist principles of “scientific” management.

During the first two decades of the twentieth century, the apparent conflict between these developments and labor union organization resulted in a compromise within the United States between management and workers. Management retained complete control of the production process, while unions gained high wages, grievance procedures, and a stable employment structure (Pikor and Sabel 1984), based on seniority rather than skill (Best 1990). Similar labor-management principles were adopted within the newly emerging mass production sectors in Britain. However, the adoption of these principles within those sectors led to a dichotomy between traditional British industry, based on family capitalism and craft-based principles of production, and the newer and more dynamic mass production sectors.

Many of the domestically owned sectors that could not imitate the mass production techniques and were still turning out small-volume or customized products were also unable to sustain the relatively high unionized wages of the new producers. The British industrial labor market thus began to exhibit different characteristics in the mass production sectors and the more traditional craft-based sectors. As the mass producers became more dominant, employment conditions in the traditional sectors deteriorated relatively. The consequent labor shedding associated with the deterioration of the traditional sectors’ competitive position also gave rise to the growth of a large nonunionized and low-pay reserve labor force, which could be hired or fired by the mass production industries as their capacity utilization requirements changed with prevailing business cycle fluctuations.

As a result of these changes, labor markets exhibited a relatively simple dichotomous employment characteristic. Workers from the shrinking craft-based and agricultural sectors provided the reserve labor force for mass production sectors such as manufacturing and food processing. The unionized core workers in the mass production sectors earned high wages and stable employment conditions relative to the blue-collar labor in the other sectors. However, the stability of these segmented labor market conditions in the production sectors was not allowed to continue indefinitely, due to the advent
of the depression of the 1930s, World War II, and the British experience of the postwar period.

The Financial Services Sector

This preceding description of the British industrial labor markets—in which structural and behavioral changes concomitant with changes in firm organization were associated with the globalizing trends within the mass production sectors—applies only to the industrial sectors. During the first half of the twentieth century, the impacts of the global investment strategies of U.S. and other foreign-owned firms was negligible on the U.K. service industries. The service sector, and in particular the financial services sector within Britain, was almost entirely unaffected by global competitive developments until the 1960s. In other words, the domestic labor market and regulatory consequences of globalization within the U.K. financial services industry initially arose almost a half century after those within the mass production sectors. The primary reason for this was that, although from the latter part of the seventeenth century onward, London had been the center of global finance, the U.K. financial system was more or less closed to external influences, with almost no foreign ownership of British-based financial institutions.

The City, London's financial center, features exchanges for all types of securities, including the largest foreign exchange market in the world. At the same time, during the nineteenth century, City institutions had expanded into FDI activities primarily by setting up local banking facilities in areas that came under the jurisdiction of the British Empire (Jones 1996). However, although the City was the world's most internationalized financial market and source of FDI, it was more or less closed to any external influences. Commercial practices within the British financial community were governed by informal rules of "gentlemanship" conduct, rooted in a common upper-class heritage of most of the City's leading figures, most of them graduates of a particular network of private schools.

Both the banking and securities sectors operated in the absence of any specific statutes defining what banking entailed, how it was to be supervised, and under what rules it should function (Coleman 1996). These elites, together with the Bank of England and the Stock Exchange, promoted an open economy and a strong currency, and vigorously opposed any political initiatives designed to construct a
national economic or industrial policy (Ingham 1984). At the same
time, the informal supervision of the Bank of England, like its more
formal counterparts in Canada and the United States, had also
traditionally discouraged the clearing banks from taking large
positions in nonfinancial firms.

During the 1930s, British deposit-taking institutions moved
toward investment management and the advisory activities
concerning mergers, acquisitions, and restructuring. Meanwhile,
their French equivalents frequently came to operate at the head of
powerful conglomerates, often under state control, while their
German equivalents tended to hold somewhat smaller positions in
smaller enterprises (Coleman 1996). As a result, although bank
funds were a more common form of finance for industrial investment
in the United Kingdom than in the United States, the relationship
between the real and financial sectors of the economy in the United
Kingdom was much weaker than in the continental European
economies. At the same time, the relatively closed nature of the
domestic financial sector meant that, while the London markets
were used to raising finance for many global investment opportunities,
the effects of the globalization process itself on the behavior and
governance of the British financial services sector were still very
limited until after World War II.

The Postwar Order
The Great Depression and World War II had profound effects on
the world economic order. The British Empire was largely dismantled,
and U.S. industrial hegemony within the western capitalist world
was unquestioned. The depression had brought with it the first
widespread experience of unemployment, as understood in the
modern sense. Despite the British origins of Keynesianism (Keegan
1992) during the 1930s, the British government had been much less
proactive in implementing policies to counter the economic and
social effects of the depression than the New Deal initiatives proposed
by their American counterparts (Galbraith 1987; Cameron 1993).
U.S. policymakers concluded that excessive competition within the
financial markets had in part contributed to the crisis. Therefore,
they encouraged rigid market segmentation within their domestic
financial markets, in terms of both market activity and market
location, to promote security over competition, while underpinning
the whole system with a government guaranteed deposit insurance
program (Coleman 1996).
At the same time as the United States restructured its domestic financial markets, it also led the way in restructuring the global financial system. The depression experience had led Western policymakers to a growing belief in a liberal international financial system that would undermine the new emerging role of the state in influencing domestic economic conditions. As welfare expenditures grew, governments required domestic households and firms to keep their funds at home in order to provide a strong domestic tax base (Helleiner 1994). Thus, policymaking was focused on expanding world trade without engendering financial instability. The Bretton Woods negotiations of 1944, and the resulting 1946 Articles of Agreement, provided for the setting up of the International Monetary Fund (IMF) and led to the creation of the General Agreement on Tariffs and Trade as a negotiating forum for tariff reductions and trade rules.

The key elements of the Bretton Woods agreements—fixed exchange rates backed by gold and the free convertibility of currencies—were designed to avoid unilateral competitive devaluations and the implementation of increasing tariff levels. The Bretton Woods system ensured stability in the world trading system, and the universal application of Keynesian fiscal policies ensured low unemployment and low inflation in all of the Western capitalist economies until the 1960s. Before this time, domestic U.S. manufacturing and financial firms were largely independent of foreign markets, and the strong performance of their overseas subsidiaries was largely dependent on the buoyant economies of their trading partners (Piore and Sabel 1984). Similarly, the stable and strong performance of the U.S. economy encouraged high levels of FDI from other Western economies into the United States. However, within the Bretton Woods system, these capitalist economies were still viewed as primarily separate entities, each with its own distinct characteristics, for the purposes of domestic economic policy and regulation.

In Britain, the depression experience and the catastrophic effects of the war on the British economy resulted in a fundamental shift in domestic public perceptions of the potential role of the state in engendering economic growth and employment. Following the Beveridge Report, and the advent of the Attlee Government in 1945, the construction of the welfare state provided for the development of a universal health, education, housing, and unemployment
insurance system, paid for primarily through a highly progressive direct taxation system. At the same time, the lack of financial aid to Britain in a form similar to aid provided Germany and France under the Marshall Plan (Cameron 1993) meant that in Britain the activities of many commercial markets had to be restricted and regulated by the continuation of the wartime quota system.

Under this “austerity” system until the early 1950s, the provision of food and many goods to individual households was regulated through a rationing system, with prices set by the state. In the financial sector, however, many of these restrictions did not apply. In the U.K. financial markets, the major clearing banks and building societies operated within a domestic system of cartels, and the Bank of England acted both in a supervisory role and as a representative of City interests in the government arena. Although the Bank of England was nationalized in 1946 and given the powers to issue “directions” to banks, it continued with its traditional, informal, and permissive approach to industry supervision. Similarly, in the securities markets, an informal system of negotiated self-regulation also developed between the industry and the state, under the auspices of the Stock Exchange (Coleman 1996).

In terms of industry structure in the nonfinancial sectors of the economy, following the mass production developments of the interwar era, the postwar era was characterized by industrial sectors dominated by large firms and a marked division between the public and the private sectors. In the production sector, wages in the large firm, mass production industries were set through bargaining between corporate management and national labor organizations. In the public sector, wage bargaining tended to track these private sector wages. The role of national unions in wage setting, plus the expansion of unemployment welfare provisions, thus ensured the growth of household consumption in line with industrial output. With its many regulated markets at the micro level, institutional labor negotiation at the national level, and Keynesian fiscal policy to control aggregate U.K. demand at the macroeconomic level, this reconstruction economy was characterized by stable growth, low inflation, and negligible unemployment. For nearly a quarter of a century, the stability of the Bretton Woods system appeared to insulate the domestic economies of countries such as the United Kingdom from the vagaries of international markets. Indeed, until the collapse of the Bretton Woods system, the U.K. economy knew
stable growth, low inflation, and negligible unemployment until the end of the 1960s, more than 15 years after the "austerity" measures had been lifted.

The 1970s and the Oil Price Shocks

During the 1960s, the stability of the international trading and financial system, which had ensured stable domestic economic conditions within the United Kingdom, started to be undermined. The U.S. dollar came under continuing downward pressure, due to increasing domestic inflation caused by the public expenditures associated with simultaneously funding the Vietnam War and increased welfare state measures. This downward pressure meant that the dollar could not continue to act as the world's reserve currency at existing parities. The result was that the Bretton Woods system collapsed in 1971 when the dollar was floated. Shortly afterward, the 1973 oil embargo by the Organization of Petroleum Exporting Countries (OPEC) and the Soviet wheat deal led to worldwide commodity-price inflation (Piore and Sabel 1984). The combination of rapid inflation and floating exchange rates meant that commodity prices became both uncertain and independent of the performance of domestic markets. Therefore, the stable environment of labor relations, corporate governance, and domestic market demand characteristic of the Bretton Woods era was ultimately shattered.

In Britain, the traditional Phillips curve-type relationships were no longer observable at the macroeconomic level. The economy experienced stagflation, in which domestic wage and price inflation coexisted with rising unemployment. In 1976, the United Kingdom became the first industrial nation to require IMF support for public finances (Hutton 1995). The ensuing political turmoil saw several changes of government, and a new Conservative administration came to power in 1979. This change of government, which introduced a New Right political ideology with a monetarist economic framework, marked a watershed in British economic policymaking and industrial relations. The ascendancy of New Right thinking within the central government brought forth a series of labor market reforms, designed to improve the ability of the national and local labor market to adjust to both local and national shocks by reducing the level of union power and increasing the level of discretion afforded to firms in determining employment conditions and contracts. This labor market legislation was accompanied by the state's dismantling of most of the postwar industrial public
sector. The new emphasis on deregulation and competition in both the real and the financial economy encouraged the search for new management, production, and human resource management practices on the part of all U.K.-based organizations, irrespective of their sector or nationality.

**Labor Market Issues: National Organization and Dichotomous Relations**

During the early part of the twentieth century, trade unions in Britain developed primarily as craft-based organizations, responsible initially for employee protection in issues relating to working conditions and safety. This particular form of labor organization was also introduced into the American manufacturing firms that invested in the United Kingdom during the interwar years. As the U.K. government traditionally adopted a laissez-faire approach to trading and investment, the immigrant firms were thus not subject to any significant national requirements or legislation regarding employment or trading issues. The noninterventionist approach of the U.K. government was a key attraction of Britain as a base for U.S. investment in Europe. At the same time, the high productivity and employment-generation capabilities of the immigrant firms ensured that the bilateral relationship between management and unions was largely cooperative.

Following the advent of the Attlee Government in 1945, whole sections of U.K. industry became nationalized. This encouraged many craft unions to amalgamate both into national organizations and also into organizations spanning many trades and industrial sectors. Pay bargaining in a wide range of industrial sectors thus became institutionalized at the national level. In the postwar era, the United Kingdom had almost no local tradition of pay bargaining. Meanwhile, the setting up of the welfare state also encouraged the creation of nationally organized unions in nonmanual sectors, related to health, education, and administration, which previously had not been unionized. The growth of the new white-collar trade unions, alongside the traditional blue-collar engineering and manufacturing unions, was a major spur for union membership, which grew to two thirds of the national work force in 1945. This was the time of greatest union membership in U.K. industrial history. The setting up of the welfare state also appropriated for the state any philanthropic role that industry might have played. Although U.K. industry had previously only exhibited a minor philanthropic role, with no
general tradition of corporate philanthropy along the lines of U.S. industry (Whitman 1999), the social welfare policies of the postwar era ultimately stifled any possible future development of such a role. During the postwar years, the high labor demand, low inflation, growth stability, and insulated market, associated with the reconstruction economy and the Bretton Woods system, meant that management-union negotiations at the national level provided a workable form of labor relations. Unions represented worker interests, while management represented shareholders' interests alone, without any major perception of paternalistic responsibility. The postwar reorganization of the state therefore institutionalized at the national level the essentially dichotomous nature of U.K. labor relations. However, the inflationary effects of the oil crisis and the increased international competition in many sectors during the 1970s rendered this form of labor organization obsolete. The asymmetric effects of differential price rises between sectors meant that national pay bargaining across industries and regions became impossible—for both unions and management. Nationally organized labor picketing exacerbated the confrontations between unions and management. In the public perception, unions became associated primarily with activities aimed at increasing members' pay, rather than employee protection. At the same time, the industrial disputes in public utilities industries, which frequently led to national power shortages, also provided a public impetus for breaking up national public monopolies.

The Industrial Revolution of the 1980s

The 1980s was a period of enormous change in the U.K. economy. The free market ideology of the prevailing government led to enormous changes both in the industrial performance of various sectors and in government policy toward industry and labor market organization, regulation, and competition.

Changes in the U.K. Production Sectors

From the early 1980s on, the structure, organization, and behavior of U.K. production industry changed dramatically. These changes were initially seen as corporate responses to global recession following the oil price shocks of the 1970s, particularly within the more traditional sectors such as manufacturing and heavy engineering. However, it would be too simplistic to assume that industrial
Restructuring within transnational establishments in the United Kingdom is simply or even primarily the result of the modern development of an "Anglo-Saxon" industrial ethos. Much of the recent changes that have taken place have been due to the rise in new forms of organizational communication and coordination, which have resulted from the advent of both new technologies and new ideas and approaches to production.

The modern inspiration for these new ideas is not all American or even Anglo-Saxon in origin, though originally developed, at least in part, by American engineers who failed to find an audience in the United States (Horsley and Buckley 1990). Human resource management strategies— involving labor market principles such as "flexibility," "quality circles," "continuous improvement," and "total quality management" within the "just-in-time" (JIT) production for minimum inventory—derive from ideas and practices common in postwar Japanese industry (Shonberger 1982; Nishiguchi 1994). These practices were credited with part of Japan's success at mitigating the effects of the oil-price shocks during the 1970s. During the 1980s, these ideas came to dominate MBA academic literature and the modern management practices of North American multinationals and other firms that felt most threatened by the competition from East Asia. Transmitted to their subsidiaries and affiliates both within and outside the United States, these ideas and practices have permeated western industry (Trevor and Christie 1988). In the United Kingdom, U.S. firms with UK subsidiaries first introduced many of these practices. However, these ideas were also mediated via the growing number of Japanese subsidiaries that located within the United Kingdom as part of a European production strategy (Delbridge and Lowe 1998), partly in response to flexible labor laws and relatively low wages and partly in response to subsidies provided via regional development agencies.

These production and distribution techniques, based on the minimization of inventory costs, were immediately attractive in the U.K. manufacturing and production sectors suffering the effects of high interest rates during the early 1980s. However, to avoid the problems of opportunism associated with managing supply chains using these techniques, the widespread adoption of JIT ideas led to a new emphasis on fostering more long-term inter-firm relations and a movement away from short-term market contracting, based solely on prices (Oliver and Wilkinson 1989).
One of the key insights brought about by the new JIT techniques was the realization within business and management circles that geography and location are important competitive issues. JIT raised the profile of location as a competitive issue. Because the new techniques required more inter-firm transactions between suppliers and consumers than the more traditional western production techniques, they had the potential to significantly increase industrial transport costs (McCann 1998). This gave firms an incentive to localize their input supplier base as much as possible (McCann and Fingleton 1996) and to restructure their geographical shipment linkages as they rationalized their operations. Moreover, the fact that these ideas were introduced into the United Kingdom by U.S. and Japanese multinational firms, competing at the level of the European Union (E.U.) markets, heightened the newly perceived importance of the geography of markets as a competitive issue.

The new emphasis on geography as a competitive issue in the nonfinancial production sectors was a major psychological change in much of U.K. industry. Although the United Kingdom had been a major global trading country for centuries, and a member of the European Economic Community since 1971, the relative stability and domestic protectionism of the Bretton Woods era had fostered a myopic isolation in many sectors of the economy. Not until after the 1970s oil crisis, however, were the disastrous competitive effects fully felt. Only during the 1980s did many sectors of manufacturing begin to consider the impacts of globalization on their competitive environment. Changes at the global level most heavily affected large firms whose markets were more geographically diverse. However, the impacts of global competition on these firms quickly came to be transmitted to a much wider sphere than simply the economic. The need for improved efficiency meant that many traditionally vertically integrated firms, which had prospered during the Bretton Woods era, became the subject of mergers, acquisitions, restructuring, or liquidation.

The impacts of these changes on host communities were more transparent when the local establishments were large, and inevitably, this was usually where such restructuring took place—within large multiplant and multinational enterprises (Rowthorne and Wells 1987). The reasons for this are twofold. First, the general population perceives the economic and social impact of large establishments on host regions to be much more significant than for small
establishments. Changes in these firms’ local economic behavior can therefore engender significant local political responses. Second, restructuring within large multiplant and multinational enterprises inherently involves the problem of place. Local observers perceive much of the effects of restructuring to be part of a zero-sum game. This is particularly true for areas that experience disproportionately adverse consequences of such changes. In the United Kingdom, the apparent geographic bias of the negative local impacts of these changes during the 1980s (Stafford and Watts 1991) led to a confrontational relationship between central government and much of local, and particularly urban, provincial government.

These corporate structural changes brought with them changes in the relationship between the firm and its workers. Rising industrial disputes became a symptom of fundamental restructuring within the labor market, as management and unions attempted to assert monopoly positions. Frequently, labor representation on a national scale meant that the site of a dispute would not necessarily coincide with its most publicized impacts. As a result, the distinction between labor market adjustment at the local and national levels became blurred.

Meanwhile, the growth of free market labor legislation and the state’s dismantling of most of the postwar industrial public sector were taking place more or less simultaneously (Keegan 1992; Hutton 1995). Privatization of many public sector industrial assets, particularly in the energy sector, generated local labor market responses (Hoare 1997) largely similar to those resulting from the effects of corporate restructuring. As much of the inspiration for the New Right ideas was perceived to have originated in the United States, and significant elements of the denationalized industries were acquired by foreign private capital, “multinationals” became a focus of negative critique by The Left during the 1980s, in both political and academic circles.

Changes in the U.K. Financial Services Sector

Even before the breakdown of the Bretton Woods system, the first modern effects of globalization on the U.K. financial sector started to take place. However, these changes in the British economy did not arise from changes within the domestic financial sector, but rather from changes in the domestic American financial sector. Early in the postwar era, the various subsectors of the tightly regulated U.S. financial sector operated under a series of different interest rate controls. As U.S. interest rates began to rise above their
controlled levels during the 1960s, due to the inflation caused by expanded government deficits. American fund managers attempted to devise new financial products to circumvent many of the controls (Coleman 1996). Short-term fund markets in London provided an alternative source of finance.

The uniquely informal and permissive supervisory approach of the Bank of England also encouraged the immigration of U.S. and other overseas-owned firms, as the Bank sought to maintain London’s competitive position within the global financial economy. By the 1960s, London became the center of the Eurodollar markets (Fishman 1993). However, the large-scale immigration of overseas-owned firms in part led to the destruction of the City competitive and regulatory practices over the following two decades, as these immigrant firms did not operate according to the City’s traditional “gentlemanly” practices (Moran 1994). The ending of U.S. capital controls in 1974 and the flood of petrodollars into London following the OPEC crisis provided further impetus toward global financial liberalization and away from the protected domestic market characteristics of the City.

When a crisis arose in the secondary banking system in 1972 (Reid 1982), the Bank of England’s informal and permissive approach to regulation came under a sustained attack for the first time, and further bank failures in the 1980s subsequently led to progressive changes in the regulatory environment. Meanwhile, in the securities markets, the organization and regulation of the Stock Exchange was also progressively brought into question. Since the war, the Stock Exchange had functioned as an oligopoly, in which there was a clear distinction between the principals, called jobbers, and the agents, called brokers, under what was known as the “single capacity rule” (Coleman 1996). However, by the 1970s, the large institutional investors—the pension funds and insurance companies, which had assumed a dominant role in the markets as both buyers and sellers of securities—sought to end fixed-commission practices and to encourage market competition (Reid 1988).

These challenges to the traditional organization of the market were accompanied by increasing regulatory problems. The progressive complexity of securities markets made it ever more difficult for industry regulation to be based on informal and traditional contacts between industry personnel. By the 1980s, these problems were exacerbated by the widespread adoption of new information technology, which permitted an enormous increase in the complexity
and speed of financial transactions. The traditional approaches to
industry supervision within the U.K. financial markets were
progressively becoming out of step with changes in the global
competitive environment.

By the 1980s, the City's traditional pre-eminent role in
international financial markets was under threat, because the uneven
effects of the global inflationary turmoil of the 1970s had altered
the relative trading advantages of many countries. Following the
lifting of exchange controls in 1979, the City's financial system had
to face the effects of globalization on the stability of the U.K.
financial system as well as to ensure that London maintained its
competitive position in the global financial market. At the time,
however, maintaining London's pre-eminent role was difficult,
because the domestic U.K. economy was weaker than the domestic
economies of the United States, Japan, Germany, and France, which
provided the bases for the competitor financial centers. Relying
solely on traditional expertise, experience, and flexibility would be
insufficient.

To maintain London's position in the world's increasingly
complex financial order, in which the boundary between securities
markets and banking was becoming blurred, U.K. policymakers
needed to modernize and democratize banking regulation and
supervision, to desegregate credit and deposit markets, to break up
domestic financial monopolies, and to modernize investor protection
systems (Coleman 1996). A series of legislation culminated in the
1986 Financial Services Act, the 1986 Building Societies Act, and the
1987 Banking Act. Together, they attempted to provide for a more
direct, though still relatively limited, state regulatory role in banking
(Penn 1989) and securities (Moran 1991) and to desegregate both
the securities markets and the market for domestic credit (Boleet
1988).

However, the short-term effects of these structural changes
within the financial markets had some major unforeseen
macroeconomic impacts. The restructuring within the financial
markets, which permitted banks and building societies to move
into each other's markets and resulted in greater unanticipated
inflows of short-term foreign capital (Miles 1992), rendered monetary
aggregates very difficult to monitor and the existing approach to
monetary policy impossible to implement. Asset price inflation,
primarily in the London and hinterland regional property markets
(Bover et al. 1989), and wage inflation, primarily in the labor
markets of the London regional service sector, forced the government to focus primarily on the relatively blunt instrument of interest rate adjustments as the primary means of controlling inflation.

The resulting high interest rates led to asymmetric shocks between the U.K. financial services and the U.K. manufacturing and production industries. Confidence in City financial markets to some extent benefited from the strength of the pound sterling, whereas the export-oriented production sectors suffered both from increased inventory holding costs and the relatively strong currency (Delbridge and Lowe 1998). The 30 percent real, inflation-adjusted appreciation in the pound sterling between 1979 and 1981 wiped out some 1.8 million jobs in manufacturing, reducing manufacturing's share of national output and employment in 1979 from 26.5 percent and 27 percent to 22 percent and 19 percent, respectively, today. It took 10 years for manufacturing output to reach 1979 levels, and even now it is only 13 percent above the 1979 level (The Guardian 8/4/99). Moreover, the asymmetric effects on employment between the industrial and the financial sectors were also mediated spatially, as the financial markets were located primarily in the London and hinterland regions, whereas the manufacturing and production sectors were located primarily in the geographically peripheral regions of the United Kingdom. Consequently, the effects of restructuring in the U.K. financial markets, in response to changes in the global competitive environment itself, also encouraged significant corporate organizational and managerial restructuring in the nonfinancial production sectors.

**Labor Market Issues: Fragmentation, Local Negotiation and National Union Decline**

Postwar industrial relations in Britain, characterized by an essentially dichotomous relationship between unions and management at both an institutional level and a national level, were rendered obsolete by the inflationary instability of the 1970s. During the 1980s, the Thatcher Government responded to the confrontational environment in U.K. industrial relations by sweeping legislative changes, which limited the ability of unions to enforce membership, to strike, and to engage in national pay bargaining. Union membership declined rapidly for several reasons. First, the traditional blue-collar industries such as manufacturing and engineering were the sectors most adversely affected by the high interest rates of the early 1980s.
These had traditionally been the sectors with the largest union membership. The steep decline in employment in these industries greatly reduced the union membership base, particularly among male blue-collar workers (The Guardian 5/4/99).

Second, firms were no longer required by law to recognize union organization within their establishment or to permit employee strike action without the threat of automatic dismissal. This became very important for many immigrant FDI manufacturing firms during the 1980s, particularly those from the Pacific Rim, which were able to adopt no-strike or nonunion labor arrangements similar to their own traditional domestic arrangements.

Third, and perhaps most important, the structure of U.K. industry has changed dramatically since the 1980s. Growth in the service sector, and in particular the huge U.K. growth in professional and financial services, has taken place primarily either in traditionally nonunionized sectors or in sectors that have developed since the Thatcher Government reorganized union and labor legislation. Less than 30 percent of the U.K. labor force is now unionized, and only 44 percent of employees work in establishments that recognize unions. When the Thatcher Government came to power in 1979, more than two thirds of employees worked in establishments that recognized unions (The Guardian 5/4/99). Union membership is now dominated by the public sector, where more than 60 percent of employees are unionized in sectors such as health and education.

Not only has union membership fallen severely, its composition has also changed. In contrast with the traditional pattern, today white-collar public sector workers, women, and ethnic minorities make up disproportionately large elements of the membership. Each of these groups is traditionally nonconfrontational in labor relations, with the result that the traditional power of unions is steadily being diminished.

The widespread legislative reforms of the U.K. labor market during the 1980s, along with the simultaneous removal of many industrial subsidies, in a sense introduced an aspect of honesty to U.K. industrial performance. Free market conditions brought competitive pressures to bear on whole sections of industry that previously had been largely insulated from the market via public ownership or agreed public sector contracts. In many of these production sectors such as the automobile industry and the basic chemicals sector (Financial Times 5/7/99), only U.S.-owned firms as a group survived the economic downturn. Sectors such as defense
aerospace and electronics, where U.K.-owned firms maintained a major domestic presence through the 1980s, often remained somewhat insulated from market pressures, due to bilateral trading offset arrangements with the United States. U.K. government purchases of U.S. military equipment stipulated that U.S. firms must place an equivalent amount of business with U.K. firms, which gave U.K. subcontractors an advantage over indigenous U.S. rivals in winning business from U.S. customers in these industries.

The generally revealed poor performance of U.K.-owned firms in comparison to U.K.-based overseas-owned firms led to a watershed in both union thinking and government perceptions. To maintain employment, trade unions began to campaign actively for increased inward investment. Unions became increasingly reliant on their approach to labor negotiations. In part, this was in order to attract investment and jobs, but also due to the fact that militancy often resulted in no unions' being recognized within the plant. Union membership and survival depended on negotiations with management from positions of relative weakness. (The Guardian 24 July 1999). Within the production sectors, labor negotiations became increasingly determined at the local level, and typically at the level of the individual establishment. At the same time, the fragmentation and privatization of much of the utilities sector (power generation, water provision, coalmining, telecommunications) during the 1980s and early 1990s meant that public sector labor negotiations, previously held at the national level, were now all localized. Blue-collar labor relations in the United Kingdom are now almost completely localized. Nationally organized labor negotiations exist primarily only in white-collar activities within the public sector, and as increasing portions of the public services are contracted out to the private sector under the principle of compulsory competitive tendering, the strength of the national unions is continuing to diminish.

During the 1980s, as U.K. production sectors were facing huge problems of employment retention and labor relations, the U.K. service sector, especially financial services, was experiencing unprecedented growth. The rise of the service sector in the United Kingdom, centered on the success of the London financial markets, was also characterized by huge growth in the number of small firms. The growth of independent small businesses in general was viewed as the principal means of employment generation across a whole range of industries. Tax concessions for self-employment were provided to encourage potential entrepreneurs to set up new businesses. At the time, the service sector and the small firm sector
were perceived as an alternative mode of employment creation, relying on nonunionized labor and the employment generation capabilities of new firms. Implicit in this policy of tax concessions was the idea that wages and working conditions in growing sections of the U.K. economy would be determined primarily by market conditions rather than by legislation. The enormous growth in the U.K. small firm sector (Hart and Oulton 1996) was dominated by the service sector and by London and its hinterland economy.

This was to some extent due to the increased loan security associated with higher property prices in the southeast, fueled by the expansion in property credit during the 1980s, and in part due to improved access to the City capital markets (Barkham et al. 1996). However, whatever the actual reasons for the regional bias in small firm formation, the observed growth of the small firm service sector, and the enormous success of the City financial markets during the 1980s, provided stark contrasts in employment and growth performance to that of the U.K. production sectors. The service sector, in particular the City financial services, exhibited low union membership. As a counterpoint to the struggling union-dominated production sectors, these new sectors and modes of employment were heralded more generally as role models for future modes of U.K. industrial labor organization. These comparisons further encouraged the continuing policy of reductions in industrial subsidies and the curbing of union powers in the nonfinancial sectors.

Current Climate

A key feature of recent industrial trends in the United Kingdom, as well as in other industrial countries, is a growth in employment in the service sector relative to employment in the traditional production sectors (Artis 1998) and a growth in the employment contribution of small firms relative to large firms (Hart and Oulton 1996). However, as shifts occurred, changes in information technology have blurred the boundary between each of these sectors in terms of both their increasing behavioral interdependence and the actual sectoral employment definitions. Modern developments in information technology (Financial Times 10/7/98) have also changed the relationships between financial and nonfinancial institutions. The increase in the quality and variety of the information available and the speed with which it can be transmitted has spread far
beyond the financial world. All forms of modern consumer demand, from services to manufactured products, have become more sophisticated and sensitive to changes in both price and quality. This has resulted in the creation of many new types of service employment associated with the customization of demand, and has further contributed to a blurring of the boundaries defining sectoral employment.

The continually increasing speed with which financial instruments and products can be developed and exchanged makes for more lively competition in financial services. The increased competition in the United Kingdom is further bolstered by increases over the last 15 years in the level of U.K. private household and institutional holdings of financial assets (Aris 1998). The resulting increase in the power of fund managers also increases the sensitivity of decision-makers in both financial institutions and nonfinancial institutions to changes in corporate share prices. This change has meant that the financial and production sectors have become progressively more interdependent. Moreover, this interdependence has been further increased as the development of new financial products has meant that the levels of external financing for industrial activities have also generally increased.

The boundary between many financial and nonfinancial production sectors has therefore become rather blurred. However, although the level of private household shareholding in the United Kingdom is higher than for other E.U. countries, it is still much lower than for the United States. The market effects are also quite different from the experience of the United States (The Independent 5/6/99). U.K. household shareholding has been driven primarily by the 1980s policy of fragmenting and privatizing state-owned monopolies, and the financial markets liberalization that allowed building societies to demutualize and become banks. There is still no widespread culture of shareholding within the United Kingdom. Most holdings are controlled by institutional investors such as pensions funds and insurance companies, whose deposits have grown since the reduction in state pension provision since the 1980s. In the United Kingdom, the major effect of these changes has been the dismantling of many of the British industrial conglomerates that had grown up during the interwar and postwar years (Financial Times 5/7/99).

The blurring of traditional industrial sectoral divisions, due largely to the opportunities afforded by information and technology,
has also taken place with the increasing integration of geographical markets. Simultaneous improvements in both information and transportation technology have allowed firms to compete more effectively over varied geographical areas by better coordinating production and distribution activities over space. This growth in spatial competition itself provides further opportunities for employment associated with the customization of demand, as firms are increasingly more able to compete simultaneously in a range of domestic national markets, many of which were tightly regulated and protected during the postwar era. The new market opportunities therefore allow many firms to attempt to achieve both economies of scale and scope across both larger and more heterogeneous market areas.

This growth in the spatial market areas for production sectors itself therefore provides further opportunities for service industry employment and a further blurring of the boundary between employment in the production sectors and employment in the service sectors. The point is that the types of employment changes and developments associated with serving geographically expanding markets often entail a redefinition of the relationship between service and production jobs instead of changes according to industrial classification codes.

The increased opportunities for global competition due to technological developments have both contributed to, and resulted from, changes in regulation and governance at the international level. In particular, the development of free trade zones such as the European Union and North Atlantic Free Trade Agreement area has stimulated cross-border investment as a proportion of global output to levels only previously reached during the last decades of the nineteenth century (Jones 1996). Further developments in regulatory harmonization and market integration will serve to continue the relative growth of global investment. However, these are changes that will affect all global trading nations, not the United Kingdom alone.

What is particular to the United Kingdom is the question of the future attractiveness of the United Kingdom as a location for overseas investment in the European Union. This has potentially enormous implications for the U.K. labor market. The reason for this is that the domestically owned portion of the U.K. production sectors is not strong enough to compensate for any downturns in
FDI, on which the United Kingdom has clearly relied over the last two decades. Therefore, any reduction in the attractiveness of the United Kingdom as a location for FDI, relative to other E.U. locations, will weaken the strength of the U.K. demand for labor in the production sectors.

For this reason, both government and unions during the 1980s responded by setting up a variety of ad hoc cooperative arrangements at the local level to encourage the immigration of more overseas-owned firms, in particular from the Pacific Rim countries. The development of these implicit contracts between labor and government bodies in the 1980s has become, in the 1990s, the basis of the widespread formation of public-private coalitions to promote local employment by means of lobbying activities. This is apparent in the two dominant U.K. sectors, namely the productive sectors and the financial services sectors.

The Production Sectors

As we have seen, the U.K. economy has been traditionally open to both inward and outward flows of FDI. The U.K. government strategy of encouraging FDI into the United Kingdom has continued. Despite the U.K. domestic economic downturn amid fears of global recession, the current level of inflows and outflows of FDI to and from the United Kingdom are both at record levels in all sectors (IBB 1998; Financial Times 7/16/98). Moreover, these FDI flows are at record levels for all forms of FDI, including “greenfield” investments as well mergers and acquisitions, within both the private and the newly privatized sectors. However, the pattern of these FDI flows suggests that they are driven as much by corporate restructuring in response to developments within the European markets as by continued liberalization within the domestic U.K. markets (Financial Times 7/16/98, 10/16/98). This reflects the increasing opportunities for geographical market expansion (Financial Times 3/5/96; 6/28/98) associated with the process of European integration. Moreover, this process itself has accelerated during the 1990s, as manifested not only by the enlargement of the community in 1995, but also by the progressive integration of the separate national financial and labor markets following the 1991 Maastricht Treaty, culminating in the adoption of the euro in 1999.

Within the production sectors, the current levels of foreign ownership in U.K. industry (Hill and Munday 1994; Dunning 1998) reflect the fact that the United Kingdom has long been by far the
most open of the major European economies as a base for inward investment (European Commission 1996). However, over the next few years, an increasing proportion of the European opportunities for exploiting the economic rents associated with industrial restructuring will arise within the continental European industrial markets, many of which have been more protected than those of the United Kingdom. Many European industrial sectors, such as manufacturing (Financial Times 3/6/97), chemicals (Financial Times 3/25/96), energy (The Economist 2/20/99), and transport-related industries (Financial Times 12/1/98) are now undergoing significant restructuring as firms attempt to achieve sufficient economies of scale to compete at the global level. As well as straightforward relocation, this process of restructuring requires firms to merge with or acquire partner firms based primarily in other domestic markets.

The advantages of geographical proximity and accessibility automatically led many European firms to merge with each other in preference to merging with firms from outside the European Union, although this is not always the case (Financial Times 5/11/98). Any geographical advantages of proximity will be further bolstered by the market transparency associated with the development of a pan-European market in terms of both currencies and common labor and industry standards (Financial Times 10/13/95). Proximity will facilitate accurate comparison of input and factor prices across neighbouring locations, thereby allowing efficient business decisions to be made. Therefore, the competitive advantage afforded by geographical proximity (Porter 1990) suggests that European integration may provide U.K. firms with new opportunities to realize the efficiency gains associated with industrial rationalization and restructuring in a growing market. Moreover, the traditional openness of U.K. industry and its history of exposure to global competition would also suggest that U.K.-based firms will already be in a relatively stronger position to take advantage of the restructuring in E.U. markets than firms and industries based in other previously more protected domestic European countries. These arguments therefore imply that U.K. production industries may be uniquely placed to exploit the new market opportunities generated by continuing European integration. However, four issues may cast some doubt on this suggestion.
First, while the United Kingdom has traditionally been the major source of European FDI in countries outside the European Union, its contribution to FDI within Europe is much lower. Over the last 15 years, at least five E.U. nations have had larger gross outflows of FDI to other E.U. countries than the United Kingdom (European Commission 1996). This suggests that U.K.-owned and U.K.-based firms are much less integrated with European markets than the raw figures of openness to FDI flows might initially suggest.

Second, the fact that a greater and increasing proportion of the U.K. production sector is externally controlled, relative to the industries in the other major E.U. economies, casts doubt on the ability of U.K. industry to take advantage of such opportunities. The United Kingdom no longer has any domestically owned major presence in industries such as automobiles, electronics, or computers, and its presence is shrinking in such traditionally successful sectors as chemicals and pharmaceuticals. Despite evidence of localized indigenous growth in some sectors (Financial Times 11/16/95; Cosh and Hughes 1996; Business Week 3/9/98), the overall scale of these developments is still small and insufficient to counter the general trend. For some observers, the United Kingdom’s reduced domestically owned presence in these European markets implies that an increasing proportion of U.K. domestic investment and production decisions will be determined primarily with respect to conditions external to the United Kingdom (Kilson and Michie 1996). In particular, decisions concerning research and development (R&D) expenditure and production innovation will be made elsewhere, potentially contributing to a further weakening in the United Kingdom’s global R&D ranking (Financial Times 6/25/98).

Third, the relative advantage of the United Kingdom as a base for American FDI due to a common language tie is being eroded, because English has developed into the common global language of business. The greater prevalence of second-language speakers in other European countries, and the recent widespread efforts by U.K. firms to encourage their personnel to acquire a second language, suggests that the United Kingdom’s linguistic comparative advantage may erode quite rapidly.

The fourth reason casts some doubt on the relative ability of U.K. industry to exploit the gains from European integration. It is the simple fact that an ever-increasing proportion of future European
investment opportunities will arise in continental European countries rather than the United Kingdom, primarily because these other domestic economies have been more closed to global competition than the United Kingdom. This implies that new inward FDI from outside the European Union may find locations in the United Kingdom less attractive than previously, because the potential gains from industrial restructuring in the United Kingdom will be so much less.

For all of these reasons, the process of European integration has recently called into question both the ability of the U.K. production sectors to continue to compete in global markets and the future attractiveness of the United Kingdom as a location for overseas investment in the European Union. The implications of this for the U.K. economy are far from clear.

The Financial Markets
A similar set of issues arises in the case of the U.K. financial markets. The immigration of FDI into U.K. financial services developed from the 1960 onward. The initial wave of FDI led to the growth of the Eurodollar markets and was primarily a response to external regulatory conditions, namely U.S. restrictions on outflows of capital. However, the Big Bang of October 27, 1986, provided a second major stimulus to FDI within the U.K. financial services sector. U.S. and European buyers immediately acquired more than half of the two dozen brokerage houses trading at the time of the Big Bang, and only three British merchant banks maintained their independence (The Guardian 9/28/96).

By the 1990s, U.K.-owned banks were minority players in the City (Financial Times 10/25/96), with domestically located foreign banks accounting for 57.2 percent of domestic banking assets in 1990, the highest level of overseas ownership of any industrial country. Similarly, in bonds the United Kingdom is the most internationalized national market, with domestic bonds accounting for only 20 percent of the market in 1990 (Coleman 1996). Meanwhile, in terms of City property assets, 20 percent of all property in the City is overseas-owned, a share that has trebled since 1983, most of the increase immediately after the Big Bang: owner occupation now accounts for more than half of it. Overseas firms now occupy 35 percent of all City offices, the major investors being U.S. financial firms. The equivalent levels of property FDI in the financial sectors
of Frankfurt and Paris are both less than 5 percent (Baum et al. 1998).

These high levels of FDI in the City have traditionally been perceived as a competitive strength, contributing to the continued success of the London financial services economy (The Economist 5/9/98). The coexistence of a relatively liberal regulatory environment and markets that are open to international competition has until now ensured that the City maintains its competitive advantage relative to other European financial centers (Business Week 3/23/98). However, continuing European integration also raises the possibility of further opening, deepening, and growth in domestic European financial markets.

Recent evidence of restructuring in some of Europe’s previously more protected domestic financial sectors (Business Week 2/15/99) suggests that market competition in Europe will continue to increase as more European institutions attempt to become global players (Financial Times 10/10/96). Although the European bond and equity markets are small relative to the U.S. markets (The Economist 11/2/98) the total market value of European equities is expected to double (Time 2/15/99) or triple (The Guardian 2/13/99) in the next six years to a figure comparable to that of the U.S. market. As the market continues to grow following the creation of the euro zone, increased future cross-border and cross-exchange capital flows will be encouraged, both of which will provide new market opportunities for European bourses.

As the major European financial center, London may be able to maintain its dominant competitive position by exploiting economies of scale in financial services (Financial Times 1/6/96). These economies center on the highly skilled labor force in the London financial markets, the provision of specialized local industrial services, and the information acquisition advantages of sectoral concentration in the City. Yet, the opportunities created by European integration may also pose some potential problems for London. Questions about the City of London’s ability to maintain its pre-eminence in both European and international financial markets has been voiced sporadically since the mid-1960s. However, the creation of the European single currency, the setting up of the European Central Bank in Frankfurt, and the United Kingdom’s decision to postpone membership in the European Monetary System, have led to genuine and growing concern among both insiders and outside commentators.
about the City's future role in Europe's financial markets (Financial Times 11/6/95; The Guardian 1/16/99; The Economist 5/9/98, 2/6/99). The reasons for this concern are similar to those concerning the competitive position of the U.K. production sectors in the expanding European markets.

First, although the City as a whole is by far the largest financial center in Europe (The Economist 5/9/98), employing more than 150,000 people directly in the money markets (The Guardian 6/28/96) and up to one million people in associated sectors (The Guardian 1/16/99), recent moves to establish various cross-border alliances between European bourses (The Guardian 7/7/98; Financial Times 7/18/98), which include London's proposed alliance with Frankfurt, suggest that some individual City-based bodies may be not be sufficiently large to compete alone in the future European financial arena. This may be especially true for U.K.-owned banking institutions, many of which appear to be less internationalized for their size than overseas-owned institutions based in the United Kingdom (Coleman 1996; Financial Times 10/25/96). A greater reliance on cross-border collaboration with other financial centers to maintain market positions implies that London's prominence may be reduced, and that London will gain a relatively smaller share of the expanding European market (The Economist 2/6/99).

Second, a significant, and relatively much greater proportion of the United Kingdom's financial markets is dominated by overseas firms. Although this may be viewed as reflecting a historically competitive open market environment, the high exposure to overseas ownership may imply that much of the investment in the City is more "footloose" than investment in other emerging European financial centers.

Third, the question of linguistic advantages of the City is now less important for the reasons discussed for the production sectors, and, fourth, the geographical isolation of London from many of the continental developments may be problematic in market sectors requiring significant face to face contact.

Detailed evidence on each of these points for the financial markets is currently limited. One possible outcome of the competitive processes under way in European financial centers may be to make activities such as international trading and fund management progressively more centralized in London, while Paris and Frankfurt develop as strong regional centers, specializing in domestic trading.
commercial banking, and investment banking for corporate clients
(Financial Times 2/16/99; Lascelles 1999). However, any perception
that the United Kingdom’s opting-out of the EMS will reduce
London’s attractiveness as a location for investment may have
serious consequences in an industry where perceptions play a key
role (The Economist 2/6/99).

The adverse effects on the City of the United Kingdom’s
decision to opt out of the first wave of monetary union do not
appear to have been significant so far. However, some recent
findings suggest that any decision to further delay entry may result
in significant firm relocations from London to other European
financial centers (LERP 1998). This conclusion is somewhat disputed
(Business Week 3/23/98). Any adverse perceptions may be reinforced
by both Paris and Frankfurt’s aggressive promotional strategies to
attract investment (The Economist 5/8/98; Lascelles 1999), allied
with their relatively favorable office market conditions both in
terms of rents (JLW 1998) and nonrental occupancy costs (D’Arcy

Labor Market Issues: Public-Private Partnerships and Local
Development Initiatives

Thus, the continued survival of the U.K. production sectors, and
the strength of the U.K. financial markets, depended crucially on
the attractiveness of the United Kingdom as a location for FDI. To
some extent this has always been true. Britain has benefited
enormously from FDI since even before the interwar years in the
case of the production sectors, and since the 1960s in the case of the
financial markets. However, while the U.K. labor demand conditions
were maintained at a high level, due primarily to the postwar
reconstruction economy and the Bretton Woods system, the extent
of the United Kingdom’s reliance on this overseas investment was
largely obscured. The economic instability of the 1970s ended the
domestic insularity of much U.K. industry, and with it, high labor
demand in these production sectors. By the 1980s, the advantages
to the British economy of being a focus for the location of FDI
investment, and in particular American investment within the
European markets, became abundantly clear, particularly from the
point of view of employment generation. The flows of FDI into the
United Kingdom in many sectors compensated for the failure of
U.K.-owned businesses. While the benefits of FDI are entirely in-
keeping with the tradition of the United Kingdom as a small, open economy, attractive to investors, and with the Common Market (Council Directive 73/344/EEC) and the Single Market (European Parliament resolution of 31 July 1997). While the UK has been more insular in its economic integration and has not participated in the European Economic and Monetary Union, it has benefited from the introduction of the single currency (the euro) and the expansion of the EU.

The continuing moves toward EU integration have further highlighted the potential positive effects of capital flight on the economy. The process of European integration has encouraged many firms to look for new or more efficient production systems, often by relocating manufacturing operations within the EU. The process of integration has also encouraged the development of a wide variety of new relationships between global business and the local economy. These relationships are mediated through mergers and acquisitions of European firms and local governments. Many national firms have previously had significant domestic market penetration, and the consolidation of those markets has led to new forms of international collaboration. For example, the United Kingdom, with its significant labor force and infrastructure, has become a major destination for foreign investment. These foreign firms provide access to the United Kingdom's market and infrastructure, and, in some cases, provide various forms of subsidies to attract such investment. These partnerships have been particularly attractive in the United Kingdom, as they are attractive to local government bodies and labor representatives, which have developed in response to the growth of these firms. However, some suggest that these new types of relationships are in some cases being developed in response to the growth of other more significant relationships. The new types of relationships between public and private sector bodies have developed as part of a larger impetus to change between the two sectors.
local government and local voters to ensure that demand for local labor is maintained in situations where collective bargaining is absent or only guaranteed at the local level. Local government agencies canvass for inward investment as part of an overall local economic development strategy, with advice and explicit support often provided by other locally based inward investment. Much of the stimulus for local economic development initiatives has been motivated by interest in the "New Industrial Areas literature," which describes the successful growth of such locally based industrial systems as in Silicon Valley in the United States and in the Emilia-Romagna region of Italy (Scott 1988). However, apart from a few very limited observations (Lawson et al. 1997), there is little evidence of such clusters in the United Kingdom. Yet, this type of lobbying activity to encourage inward investment and local growth has since been extended by informal coalitions of regions or cities within different E.U. countries, which jointly lobby for mutually beneficial forms of investment (Delmaide 1994), independent of any national government initiatives. These activities can all be broadly grouped under the heading of "territorial competition" (Cheshire and Gordon 1995).

Some commentators view the process of territorial competition as simply rent-seeking activity, whereby a firm's locational flexibility effectively provides it with monopolistic power to encourage local jurisdictions to compete by offering lower factor service costs. Others, meanwhile, contend that the local existence of globally competitive firms can sometimes foster positive local externalities in terms of labor skills, management practices, and information spillovers that more than compensate for the public expenditure (Haug et al. 1983).

However, irrespective of the merits or benefits of such programs, the development of these new public-private sector arrangements in response to global competition has itself contributed to a redefinition of many central and local government roles. This is most notably seen in terms of the setting up of English Regional Development Agencies, which will adopt many of the promotional activities previously the responsibility of central government ministries. These agencies will follow the policies of their Scottish and Welsh predecessors and explicitly foster constructive relationships with global firms in areas such as labor training, industrial marketing, promotional area plans, and infrastructure provision as part of their overall strategy of attempting to maximize the specifically
local gains from global competition. Moreover, the greater the sectoral concentration of activities in an area, the greater will be the opportunity for highly targeted promotional activities, tailored to the needs of individual local sectors and reflecting the sectoral membership of local business associations (Bennett 1998).

These local coalitions have so far developed between unions, private firms, and local government bodies primarily in areas dominated by production sectors. This is in part because they are usually the areas with the greatest perceived need for proactive approaches to attract inward investment as well as the targets for trade unions have been attempts to define a new role for themselves. However, there are signs that some similar types of coalitions may be beginning to emerge in the largely nonunionized financial services sector. Reflecting the growth of concern for the City’s future, senior City figures have recently embarked on a series of visits to U.S. and European capitals, in an attempt to assure politicians and financiers that nonentry into the EMS will not adversely affect London’s advantages as a location for investment (The Guardian 1/16/99; The Economist 2/6/99). At the same time, various collaborative groupings of City business and governmental interests are sponsoring research into the implications of European integration for the future attractiveness of the City as a location for investment (LERF 1998). The outcomes of these public-private collaborations, and how they might develop if at all, are not clear.

As we have seen, the City and government interests have traditionally had an arm’s length relationship, mediated via the Bank of England and the self-regulatory bodies. Statutory control in the markets has increased since the creation in 1997 of the Financial Services Authority as a super-regulatory body, replacing the previous nonstatutory system of self-regulation, but City interests and governmental interests are still not close. Developments in Europe may, however, lead to a convergence between City interests and those of the national government regarding currency decisions. At the same time, the proactive lobbying by City interest groups to promote London as a location for investment (Financial Times 12/30/97) may forge new alliances between specifically local governmental interests and the private financial services sector. However, these potential alliances are still embryonic, partly because the reasons for their development have only recently begun to be apparent and partly because the whole structure of government in London is soon to change.
The Blair Government has continued the Major government’s commitment to financing local infrastructure investment through public-private partnerships, in the belief that private capital brings in private sector management expertise to local projects. The European Community also favors partnership funding for regional regeneration projects. However, public-private partnerships in London have been inhibited by the abolition of the Greater London Council by the Thatcher government, and this has led to claims that London’s infrastructure has been neglected. The Blair Government is reforming London’s government to address this problem.

These processes, in which many aspects of governance within the United Kingdom are becoming progressively more decentralized, are taking place at the same time as increasing European integration is encouraging greater centralization of governance at the international level. The labor directives associated with the social chapter of the 1991 Maastricht Treaty initially appeared to pose a threat to U.K. management by requiring that works councils, comprising all stakeholding members of a firm including labor, would need to be consulted regarding all operational decisions affecting employment (Addison and Siebert 1997). However, unlike many other E.U. countries, the United Kingdom has no tradition of works councils. Labor disputes were traditionally dealt with at the individual establishment level, primarily by the local branches of nationally organized unions. The labor reforms of the 1980s then reduced the power of the unions to the point where they frequently played no part in labor relations questions and were thus in no position to force firms to adopt the directives. This weakness was reinforced by the United Kingdom’s decision to opt out of the directives agreed by the Maastricht Treaty social chapter. However, even after the United Kingdom adopted the Maastricht directives in 1997, the fact that proposals for works councils within multinational firms have received little support to date at the E.U. level (Tsoukalis 1993) limits the extent to which such a requirement can be enforced.

On the other hand, the continuing integration of firms across the European Union implies that the labor relations practices of U.K. establishments will progressively become more integrated with the practices of their partner establishments in other E.U. countries. There is evidence that this pressure for harmonization of labor practices and relations within E.U. transnational firms is encouraging some U.K. firms to adopt a variety of arrangements.
that provide for joint consultation between management and labor on issues relating to employment and company performance (Ulman et al. 1993). Barclays bank has been a notable leader in such developments. For similar reasons, even before the United Kingdom officially adopted minimum wage legislation in 1999, many multinational firms, organizing their operations at a pan-European level, spearheaded the adoption of intra-firm minimum wages across the European Union. These intra-firm labor market developments are all testament to a slowly increasing convergence process in labor relations within the European Union, even beyond those legislated by the various E.U. treaties.

The opposing tensions between the development of new coalitions at the specifically local subnational level, taking place at the same time as the harmonization of much labor market governance at the E.U. level, largely reflects the fact that many of the roles and decision-making powers afforded to the state during the postwar era are no longer applicable at the national level. Global competition widens the competitive arena beyond the boundaries of the nation-state, while often simultaneously impacting primarily on economies at a local level well below that of the nation-state.

Conclusions

Of all the European economies, the U.K. economy most closely mimics the U.S. economy in terms of industrial relations and corporate governance. Although both countries share a common Anglo-Saxon tradition of business practice, many fundamental features of U.K. and U.S. industry are historically quite different. As a result, the responses of labor relations and corporate governance to globalizing influences may be rather different in the two countries. In particular, the role of E.U. integration will have a continually increasing influence in the United Kingdom.

The major merger activity of the interwar years led to the adoption of the American model of managerial organization as the main type of firm organization for U.K-owned firms. With the huge influx of U.S. corporations into the United Kingdom both before and after World War II, the American model of mass production became the norm for many industrial sectors.

The traditionally noninterventionist approach of the U.K. government, allied with a common language base, encouraged the growth of two-way flows of FDI between the U.S. and the U.K.
production sectors for many decades. By the 1980s, the influence of U.S. industrial thinking on U.K. industry meant that the American model of the MBA had come to be accepted as the common currency of management employment in many sectors. However, by the 1980s, these inward flows of FDI also came to be dominated by Far Eastern, particularly Japanese, investment. This change in the source of much FDI within the United Kingdom spawned a cultural change in business thinking. U.K.-based firms were now the first in Europe to follow the United States in adopting many of the new ideas introduced by these Japanese firms. Global competitive influences on U.K. industry were now mediated by firms dealing primarily with both American and Asian markets, but which were increasing their presence in Europe. The primary sources of competitive influences were different from the location of the dominant market areas.

Meanwhile, in the U.K. financial services sector, the effects of globalization were felt initially during the 1960s, but more fundamentally during the structural and regulatory changes of the 1980s. Once again, during both periods, the influence of U.S. industry had been dominant in reshaping the U.K. competitive environment.

During the 1990s, the characteristic dominant effects of global competition on the United Kingdom began to change. The major influences on all U.K. industrial sectors became the increased opportunities associated with continuing European integration. Cross-border restructuring and rationalization are continuing apace, in which the U.K.-ownership of industrial enterprises and sectors becomes related to the question of European ownership and control. Because in many sectors U.K.-owned firms cannot compete internationally alone either, for reasons of insufficient size, technology, or expertise, they seek mergers or acquisitions, in particular with other E.U. firms. However, these opportunities have also created new competitive threats to U.K. business as European sectors become increasingly internationalized.

The process of internationalization within Europe will determine both the geographical and cross-cultural nature of U.K. labor market behavior and corporate governance because U.K. firms will become progressively more subject to E.U. labor market legislation. The precise long-run impacts of these processes on either the financial or the production sectors are unclear. However, U.K. industry and government interests will generally argue that the strictures of
global competition will require the promotion of a relatively liberal labor market environment in Europe, contrary to the traditions of some of the other E.U. nations. At the same time, the integration of U.K. firms with other E.U. firms will require some harmonization of labor practices between the traditionally lightly regulated labor market of the United Kingdom and the more regulated and legislated labor markets of other E.U. countries.

U.K. industry differs from U.S., or German, industry in its lack of a real tradition of corporate philanthropy or paternalism. The initial reason for this difference, from the early twentieth century onward, was that shareholders perceived themselves to be excessively taxed by labor interests via the standard U.K. model of union-management wage bargaining. Furthermore, the creation of the welfare state by the Attlee Government appropriated for the state any possible further role for corporate philanthropy. Although there has been no indication of a widespread change in the lack of a corporate philanthropic culture in the United Kingdom, the local effects of globalization are providing some tentative indications that public-private relations and union management relations may be changing in the direction of more collaborative arrangements and the formation of various coalitions at the specifically local level. There is also growing evidence of new developments in relations between private enterprises and public sector bodies as well as within other parts of Europe (Cheshire and Gordon 1995).

The growth of global competition is therefore leading to changes in the domestic U.K. governance of both firms and the public sector. Domestic responses to globalization are contributing to the reshaping of many aspects of the relationship between government and the private sector, at both the national and subnational levels.

During the 1980s, a centralizing tendency within many aspects of U.K. government administration resulted largely from attempts by national government to reduce local government financial discretion (Dynes and Walker 1995) as part of an overall policy to control the growth of the U.K. money supply. Yet, the specifically local effects of global competition have contributed to a redefinition of the relationship between local and national government in the United Kingdom, with local government bodies acquiring a much more significant role in economic development issues. Meanwhile, local trade unions also have entered into coalitions with local industrial and government bodies to promote and sustain inward
investment. These changes in the relationships between the public
and private sector, central and local government, and unions and
management are also contributing to the possible development of
some new philanthropic roles for U.K. industry such as sponsorship
in local higher education institutions. Within the United Kingdom,
these developments have been much talked of recently under the
general heading of a "stakeholding" economy (Hutton 1990). Whether
a corporate philanthropic culture will develop, along with the
decentralized public-private partnerships as part of a new model of
corporate governance in the United Kingdom, is highly debatable.

Exactly how the United Kingdom will adapt to all of these
changes over the coming decades is difficult to predict. However,
a key feature of British society historically is a propensity to adapt
to prevailing conditions. U.K. industry has neither any particular
characteristics nor does it exhibit any particular type of structure
that can be discussed in a similar vein to the Japanese or German
models of production or the American system of manufacturing.
The only essential characteristic of U.K. industry is its openness to
external influences. To a large extent, this reflects the basic
characteristic of Britain as a nation built on trading activities rather
than principally on production activities. This trading culture has
meant that U.K. industry, along with U.K. culture in general, has
been defined in terms of what the United Kingdom perceives itself
to have achieved (Paxman 1998), and this perception is continually
changing. At the same time, U.K. governance is both reactive and
pragmatic. The clear winners in future globalizing trends will be
the private sector actors that can choose from among a variety of
transnational networks to complete their financial transactions
(Cohen 1998). This belief implies that the U.K. government will
progressively seek mutually beneficial alliances between itself and
these actors. As we have seen, this has always been the policy of
U.K. industry. This may eventually bring government and global
corporate interests more into line with each other.
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