

# Fighting Short-Termism with Worker Power

*Can Germany's Co-Determination System Fix American Corporate Governance?*

**Report by**  
**Susan R. Holmberg**

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## About the Author

**Susan R. Holmberg** is a political economist and a Fellow at the Roosevelt Institute, where she researches and writes on inequality and corporate governance issues, particularly around climate change and CEO pay reform. Susan is the author and co-author of publications including *The Hidden Rules of Race*, *Boiling Points*, *Rewriting the Rules* (with Chief Economist Joseph Stiglitz), and numerous articles and reports on executive pay, including *The Atlantic* article, “Can CEO Pay Ever Be Reeled In?”

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## ***Executive Summary***

This paper compares the American and German corporate governance systems, arguing that the German stakeholder system of co-determination, which gives legal rights to workers to co-manage corporations, has held back the forces of short-termism<sup>1</sup> that have dominated American corporations for the past three decades, driven our inequality crisis, and weakened our economy.

Although politically implausible, a national law requiring the boards of public companies to include worker representatives—a key element of co-determination—would, in one fell swoop, upend our current shareholder-oriented corporate governance model and redefine it as a stakeholder system, creating resilience against the pressures of short-termism. Workers especially, who are investing in companies with their own labor on a daily basis, have a legitimate claim as corporate stakeholders, and it will serve companies, and society more broadly, if we—on the left at least—felt empowered enough to stake this claim.

There are other policy options besides co-determination, particularly different worker ownership models, including employee stock ownership plans (ESOPs) and cooperatives, that would also combat short-termism. However, the larger point remains: Any benefits provided to workers that lack meaningful stakeholder decision-power will fail to foster a sustainable, long-term oriented system for any stakeholders, including workers.

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<sup>1</sup> Defined by Abernathy et al. (2016): “Short-termism is a corporate philosophy that prioritizes immediate increases in share price and payouts at the expense of long-term business investment and growth.”



# Introduction

As the economic inequality debate evolves, increasingly more analysts are looking beyond globalization and technological growth to the role that corporate decisions have played in driving down median wages, compressing job growth, and exacerbating inequality. The dominant way of doing business in the U.S., which places an emphasis on shareholders' next-quarter dividends—coined short-termism<sup>2</sup>—is being called to task.<sup>3</sup>

Overcoming this challenge is essential for putting the economy on better footing. A pivot towards long-term investment and growth is the only way to foster healthy, innovative companies that provide good jobs and meet the many challenges of the 21<sup>st</sup> century. Given the politics of the day, spotlighting the ways that over 40 years of shortsighted corporate decisions drive our inequality crisis and hinder job creation has never been so important.

Policy recommendations for reforming corporations are abundant. The Roosevelt Institute's own report on the topic—*Untamed: How to Check Corporate, Financial, and Monopoly Power*—includes a range of solutions, from updating antitrust laws to tackling the trade deficit to corporate governance reform (Abernathy et al. 2016).

Corporate governance—the formal study of how and why companies make decisions—is shedding some of its relative obscurity in broader policy debates because it pertains to a range of core inequality concerns, including skyrocketing executive pay, the heavy use of stock buybacks, workers' declining bargaining power, and unfair tax policies. Yet, most of the corporate governance scholars who have raised these issues are on the philosophical margins of a field (at least in the U.S.) dominated by a “shareholder primacy” ideology,<sup>4</sup> which has played an essential role in our current inequality crisis. How our current corporate governance system drives inequality and its associated problems is surely not on the minds of proponents of shareholder primacy, who believe in its merits so entirely that they predict all existing “stakeholder” systems<sup>5</sup> will ultimately converge to their shareholder ideal.<sup>6</sup>

This paper analyzes the German corporate governance model and argues that, despite instituting many reforms in response to encroaching global markets, Germany, the standard bearer of stakeholder capitalism, has by no means converged to the shareholder model. Germans have instead adapted their system while remaining true to their values, including recognizing workers' rights and contributions and a commitment to long-term strategy and investment. Further, Germany's unique system of co-determination, which legally recognizes workers as corporate decision-makers, has been a key apparatus for pushing back against the pressures of shareholder ideology.<sup>7</sup> In other words, it is not only a defining

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<sup>2</sup> We use the term short-termism with some reluctance. While it is a quick way of describing the shift toward “quarterly capitalism,” the term obscures the fact that this trend results from executives and shareholders committing what William Lazonick (2017) calls “predatory value extraction” from firms and from workers' paychecks. Any discussion about curbing short-termism should elevate that fact.

<sup>3</sup> As one example, see Martin (2015).

<sup>4</sup> As we describe in the next section, shareholder primacy ideology is the belief that shareholders are the only legitimate corporate stakeholders to consider when corporations make decisions. Cornell Law Professor Lynn Stout calls it “shareholder value thinking.”

<sup>5</sup> A stakeholder model—or the “Continental” model because it can generally be found in northern Europe—simply means that corporate decision-makers consider multiple stakeholders rather than just shareholders. We will define these models in more depth in the next section.

<sup>6</sup> The most well-known example of this thinking is Hansmann and Kraakman's (2000) “The End of History for Corporate Law” in which they argue “ideology of shareholder primacy is likely to press all major jurisdictions toward similar rules of corporate law and practice.”

[http://www.law.harvard.edu/programs/olin\\_center/papers/pdf/280.pdf](http://www.law.harvard.edu/programs/olin_center/papers/pdf/280.pdf)

<sup>7</sup> Being a corporate stakeholder does not necessarily imply decision-making status. Many shareholders do not have this power. In a stakeholder model, a corporate stakeholder is simply a party whose interests matter in corporate decisions. Germany's stakeholder model is particularly strong



characteristic of Germany's corporate governance model, it seems to have played a powerful role in preserving and maintaining their stakeholder system as a whole.

To argue these points, we compare the American and the German corporate governance systems to illustrate how these two different models evolved. In the U.S., the corporate governance era between the 1940s and the 1970s, which some characterize as a stakeholder system, helped to create enormous prosperity. Managers created a range of strategies that guided companies for the long-term and benefited workers. Yet, this system was also incredibly vulnerable to the ascendant shareholder movement of the 1980s and 1990s because, among other reasons, workers did not have legitimate—a.k.a. legal—rights with which to protect their jobs, benefits, and their standing as valuable contributors to companies.

After post-war reconstruction and again in the 1970s and 1980s, the German model of stakeholder governance was revered for driving the country's robust business performance, but it lost some acclaim in the mid 1990s—after reunification—as exports, corporate sales, and GDP growth rates declined. In the 2000s, Germany instituted many shareholder-oriented reforms yet simultaneously reinforced co-determination. Of course, the German corporate governance model has its limitations, but it continues to give workers a decision-making status, which has not only protected them, but has also helped German companies to adapt to changing market pressures, kept destructive shareholder primacy practices like executive stock options in check, and protected their high-quality standards and deep commitment to long-term strategy. In other words, it has likely helped prevent convergence to shareholder primacy.

This argument has many implications for current U.S. policy debates, particularly whether we ought to institute our own co-determination system. As criticisms of shareholder primacy increasingly arise, more advocates are pushing for worker-centric reforms, including employee stock ownership plans (ESOPs).<sup>8</sup> Yet, if corporate governance, like all governance, is ultimately the struggle of different stakeholder interests, then we need to think about reform ideas in terms of how we build true stakeholder power for workers that can sustain itself against oncoming structural pressures. ESOPs are not likely to build that kind of stakeholder power because they offer worker ownership without worker co-management, but they are a move in the right direction and a step that can be taken within the current shareholder primacy system.

Co-determination, on the other hand, would dramatically shift the power dynamics amongst key stakeholders as well as fundamentally reorient corporate strategy. A national law requiring that the boards of public companies include worker representatives—a key element of co-determination—would, in one fell swoop, upend our current corporate governance model and redefine it as a stakeholder system. The right strategy is likely to pursue both ESOPs and co-determination in concert, while understanding that they have dramatically different effects. What is important in debating policy solutions is to underscore the point that treating workers as corporate stakeholders—i.e. treating workers as though their interests, ideas, and efforts matter—is well past due and will create a more resilient and productive corporate governance system for all stakeholders, not just workers.

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because workers have decision-making status.

<sup>8</sup> For example, see Blasi et al. (2017).

## ***Paper Outline***

The next section—***What is Corporate Governance?***—offers some introductory background on the corporate governance topic. It also compares competing definitions of corporate governance and presents our own definition based on our explicit conviction that workers are inherently corporate stakeholders and should be recognized as such.

The following section—***Four Stakeholders***—is the bulk of the paper and compares the U.S and German systems by breaking them down between four stakeholders (or bodies of stakeholders) and summarizing their similarities and differences.

The final section—***The Power of Co-Determination***—argues for co-determination’s role in constraining shareholder primacy in Germany, evaluates why the U.S. has not instituted the system, and discusses whether we should now aggressively pursue co-determination.

## ***What is Corporate Governance?***

Defining corporate governance would be an incredibly dry academic exercise except for the fact that different definitions are rife with ideology about who matters and who doesn’t to a corporation. These framings can either fuel or constrain our thinking about the role of corporations in our society. The burgeoning awareness that our short-term oriented shareholder model is neither serving us well nor is inevitable means we are empowered to challenge the dominant meaning of corporate governance in the U.S.

### **Background**

The field of corporate governance is a relatively recent formation, developing in the 1980s as the shareholder revolution in the U.S. was getting underway. Its foundations are generally attributed to Adolf Berle and Gardiner Means’s 1932 classic, *The Modern Corporation and Private Property*, in which they argued (along with other scholars, including Adam Smith) that, during the “Great Merger Movement,” ownership of companies had become separate from their management in the early 20<sup>th</sup> century. In other words, the vast array of smaller businesses that existed up until the late 19<sup>th</sup> century were run by owners. But as these companies consolidated and became more powerful players in the market, professional managers, who didn’t necessarily have an ownership stake in the business, took over these leadership roles.

Although Berle and Means themselves viewed shareholders as having little to do with corporate governance,<sup>9</sup> the distinction they made between ownership and control is the basis for modern agency

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<sup>9</sup> Berle and Means recognized that public shareholders had little to do with corporate governance, and hence did not pose the governance problem as an agency problem. They argued that managers could become too powerful, but they did not look to shareholders to hold them in check (Lazonick 2016).



theory, which frames the problem of corporate governance as a conflict of interest between managers and shareholders.

Given that the corporate governance field was growing concurrently with the shareholder model, it is not surprising that most corporate governance literature, at least published in the U.S., draws so heavily from this framework. Pick up a corporate finance textbook published in the U.S. and you are likely to find a definition of corporate governance that defines company purpose as making decisions solely to benefit shareholders. It is no wonder most Americans take this idea for granted—it has been baked into how we educate business, law, and economics majors for decades.

### **Competing Definitions**

As one example of a shareholder-focused definition—also called the Anglo-American model, as it's primarily found in the U.S., the U.K., Canada, and Australia—Graham and Smart define corporate governance as the “activities involved in developing company-wide structures and incentives that influence managers to behave ethically and make decisions that benefit shareholders” (2012). More bluntly, Shleifer and Vishny define corporate governance as: “The ways in which suppliers of finance to corporations assure themselves of getting a return on their investment” (1997: 737).

By contrast, the simple premise of a stakeholder model is that a corporation has multiple stakeholders. As such, corporate governance is understood as “the framework of rules and practices by which a board of directors ensures accountability, fairness, and transparency in a company’s relationship with its stakeholders: financiers, customers, management, employees, government, and the community” (Business Dictionary 2017).

Stakeholder systems—found in many European countries and called the “Continental” model—tend to favor long-term strategy over quarterly returns. Some critics argue that the stakeholder model is logically inconsistent because it is impossible to meet the needs of all stakeholders (Tricker 2012). Yet, focusing on the long-term health of the company will go a long way towards incorporating multiple stakeholder needs; for example, investing in workers and investing in a business go hand in hand as demonstrated by many examples of the Continental model. They vary in terms of their institutional paths, but the common element is that they all recognize, formally or informally, the importance of multiple stakeholders, particularly workers.

In terms of developing a corporate governance system that suits our current inequality debate, the stakeholder definition is certainly an improvement on the shareholder version, but it still misses important dimensions of corporate governance. Without an accurate, useful definition, we won't change our thinking about corporate governance models and how well they function to create prosperity (and for whom). For example, Clarke and Branson (2012) argue that a definition should allow not just for accountability, but should also recognize value creation, innovation, and strategy. In addition, Aguilera and Jackson emphasize the role of power in corporate governance, an essential factor in understanding any aspect of inequality. They define corporate governance as “the study of power and influence over





decision making within the corporation” (2010: 5).

Blair and MacLaury frame corporate governance as “the whole set of legal, cultural and institutional arrangements that determine what publicly traded corporations can do, who controls them, how control is exercised, and how the risk and returns from the activities they undertake is allocated” (1995, 3). This can encompass the above issues, but perhaps is too academic.

Inspired by the above, particularly Blair and MacLaury, we offer this definition with which the following discussion of both the American and German corporate governance models is interpreted:

Corporate governance is the set of rules<sup>10</sup>—both internal and external—that shape who makes corporate decisions, what those decisions are, and who benefits and who loses from those decisions.

This definition is simple yet leaves room for accountability, innovation and value creation, and power relations—and the policies (both internal and external to the business) that can change those dynamics. It allows for the notion that workers are corporate stakeholders and that their well-being matters. It also reflects the idea that corporate governance systems are malleable and ripe for change. Rules change, through federal, state, and municipal policy, and through shifts in economic conditions and power amongst various stakeholders.

## ***Four Stakeholders***

To make a simple and useful comparison between the U.S. and German corporate governance systems, the following breaks them down according to the role, influence, and interests of four key stakeholders (or bodies of stakeholders—in the case of boards): managers, boards, shareholders, and workers. These categories can overlap. For example, in Germany, managers, shareholders, and workers all serve on boards. Additionally, these four are certainly not the only corporate stakeholders, but they are arguably the most central participants in terms of framing how companies operate and for whom.<sup>11</sup>

The first subsection below describes the U.S. system prior to the 1970s, the second the American shareholder model, the third the German paradigmatic stakeholder system, and the fourth the German model today as it has adapted to globalization. We conclude this section by making some top-line comparisons of these changing systems.

### **American Corporate Governance: 1940s to 1970s**

The period between the 1940s to the 1970s is often called the “Great Prosperity” or the “Golden Age of Capitalism.” During those years, unemployment was low, wages at every level steadily climbed, and the growing middle class was the engine of our economy, buying homes, cars, and other goods that fueled job

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<sup>10</sup> We use the term “rules” as a shorthand for policies and social norms that structure economic outcomes.

<sup>11</sup> Other examples of stakeholders include households, creditors, suppliers, and community members.





creation.

A range of factors drove this expansive era, including strong government investment, a solid safety net, and union protections. Yet, corporate governance—as it is becoming increasingly recognized—is an additional factor of importance. As we discuss below, managers had enormous sway in running businesses for the long term and they generally retained and reinvested earnings back into the company, including in the workers they viewed as essential to business success. Shareholders' interests were valued but were not elevated above all else, and boards generally fell in line with management's strategy.

### Managers

The role of corporate manager was born during the Great Merger Movement of the late 19<sup>th</sup> and early 20<sup>th</sup> centuries. Most companies were small and run by managers who owned a sizeable portion of the business. Yet, industry was morphing from thousands of small manufacturing firms into fewer large corporations. As ownership shifted, employee-executives gradually took over the role of manager, and “management” became a profession. By the 1920s, almost all large companies were controlled by the managerial class.

According to Walter Kiechel, writing in Harvard Business Review, this new elite class of managers, armed with new theories about the science of management, were lauded as the answer to the country's problems, particularly the Great Depression, the social upheaval it wrought, and the ineptitude of the Hoover administration to address it. This continued into the period from the 1940s through the 70s, becoming “managerialism's era of good feelings, its apogee of self-confidence and widespread public support” (Kiechel 2012).

In exchange for this good will and in the context of much stronger labor bargaining power vis-à-vis strong unions and tight labor markets, managers generally ran companies, not for the next quarterly share returns, but for the long run. CEOs recognized they had several goals and stakeholders in mind: to make quality products, to provide a decent living for their employees, to provide solid returns to their investors, and to perhaps even contribute to the broader community and the country (Stout 2012). At the same time, executive compensation was much more moderate than today's rates. According to Frydman and Saks (2010), between 1940 and 1970, average CEO pay remained below \$1 million (in 2000 dollars).

### Boards

As opposed to the lauded, powerful manager positions, corporate board members were passive “insiders”—other executives, creditors, suppliers, etc.—who were hand-chosen by managers and generally beholden to them rather than providing meaningful oversight. Peter Drucker, the famous management consultant, went so far as to characterize these board members as just figureheads (1946). Notably, despite the weak and passive position of corporate board members, some scholars describe their stated purpose during the “managerial era” as managing corporations, as opposed to the more recent role of monitoring executives on behalf of shareholders, which demonstrates a striking difference



in the theory of corporate strategy, if not the practice, between governance eras.<sup>12</sup>

### Shareholders

Shareholders also held little power relative to managers. In 1951, over 90 percent of stocks were owned by individual households, particularly the wealthiest groups (Snider 2013). The remaining were held by institutional shareholders like pension funds and mutual funds. Because share ownership was so diluted, shareholders were generally much more passive than today's majority institutional shareholders. They had little power to push against management's strategic initiatives like generous worker benefits or new investment strategies. Over the course of this era, outside shareholders were much less likely to lead a proxy fight,<sup>13</sup> and large companies were wary of cutting dividends.

### Workers

Progressives rightly laud the era between the 1940s and the 70s as good for workers and the middle class. Within companies, the good pay and benefits workers received during this time was simultaneously driven by both union pressure and managers who were motivated to minimize union power in the face of a much more powerful European labor movement. Unionization peaked in the mid 1950s, but enough of the workforce remained organized in the two subsequent decades to enable unions to remain a major force in securing the broad sweeping benefits that employees enjoyed. According to Jacoby (2005), most managers were amenable to these benefits because they preferred welfare capitalism—whereby benefits are provided by businesses rather than the government—to the strong welfare state and tax policies that were being instituted in Europe. They initially sought to secure worker loyalty through training schools and safety programs and eventually through health insurance and pensions. Lifetime employment policies were the norm in larger firms. To shareholders who objected to spending on these programs, managers argued that it was economically rational as it reduced union activity and employee turnover and secured profits for the long term (Jacoby 2005).

### **American Corporate Governance: The Shareholder Model**

The strategic commitment to long-term investment in workers and capital came under threat in the early 1970s as U.S. economic growth turned sluggish due to inflation and competition coming from the rebuilding post-war economies of Europe and Japan. Beginning in 1982, as the stock market rebounded from its late 1970s malaise, a takeover market percolated, which emboldened investors to demand that companies do more to extract value from corporate coffers (Jacoby 2005).

As shareholding became increasingly concentrated, institutional actors were also empowered by changing ideology about the very purpose of the corporation. Economist Milton Friedman unleashed the shareholder revolution when he wrote in 1970 that corporations' only responsibility was to "make as much money as possible." In 1976, Jensen and Meckling formalized Friedman's logic when they launched the still-dominant agency theory, arguing that the main purpose of corporate governance is to

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<sup>12</sup> See the edited volume Clarke and Branson (2012).

<sup>13</sup> A proxy fight is when a group of shareholders join forces to gather enough proxy votes (i.e. votes cast by shareholders without attending the annual shareholders meeting) to win a corporate vote.



find ways to align the incentives of shareholders and executives, completely erasing the notion that workers had any real stake in building the business.

The effects of this corporate governance model are becoming more familiar in recent debates. Exorbitant executive pay has become a key driver of our inequality crisis. Heavy use of stock-based performance pay has led to a misuse of resources (sometimes even fraud) and economic instability. The surge of stock buybacks at the behest of shareholders has diminished corporate investments in innovative activities like research and development and reduced the number of good jobs. And corporate power has concentrated at levels not seen since the Gilded Age.

### Managers

This shift in ideology dramatically diminished managers' power to decide broad corporate strategy. Much less likely to be hired internally, managers were pressured to shift from what Lazonick (2015) calls a retain-and-reinvest approach of the earlier governance system to a downsize-and-distribute approach. Rather than striving to create quality products and services, investing in their workers, providing strong returns for investors, and generally managing for the long term, executives are tasked with managing for the singular purpose of maximizing share price.

This mandate became embedded in pay policies when, in the 1990s, Michael C. Jensen and Kevin Murphy famously argued that the best way to induce CEOs to act for shareholder interests alone was to compensate them with “performance pay” that should be directly tied to share price. This recommendation, along with a 1993 tax policy that made stock options and stock grants cheaper to issue, triggered an explosion in their use and drove pay totals in general into the stratosphere.

### Boards

Since the 1980s, the nature of the corporate board has changed in form but not in relative power. Due to both policy reforms and a shift in governance norms, they became smaller and less commonly staggered, were comprised of more outsiders, and were charged with monitoring executives to maximize shareholder value rather than thinking about day-to-day management. Yet, by any measure, board members are still beholden to CEOs in many ways. CEOs have enormous influence over the board nominating process and sometimes exert their power to block nominations. Beyond elections, CEOs can use their control over the company's resources to legally (and sometimes illegally) bribe board members. In fact, there is strong evidence that companies with higher CEO pay compensate their board members more generously, a clear indication that board members are engaged in a corporate liaison with CEOs rather than serving as independent parties that can assess the appropriate award for a CEO's performance. As Schwartz (2017) argues, because they are less invested as stakeholders, board members are less generous with their time than they are with doling out money to executives.

### Shareholders

Once dominated by wealthy households, today the majority of stock ownership is managed by institutional investors—pension, mutual, and hedge funds—on behalf of individual investors. While



individual household investors are in it for the long haul, institutional investors feel the pressure to attract clients by showing them higher and higher returns. Hedge funds, increasingly behaving as “activist investors,” are driving the pressure on managers to cut expenses, particularly by using available cash to buy back stocks, sell off company assets, and merge with other companies on the hunt for double-digit returns. Economist William Lazonick’s research has demonstrated that buying back stocks—essentially redirecting available cash from investments to repurchase shares—is a key corporate strategy for temporarily driving up share prices (and offsetting the effects of stock options).<sup>14</sup> So too is buying up companies, which has resulted in a new wave of concentration of corporate market power.

A crucial question is whether shareholder primacy actually benefits shareholders. As Stout (2012) argues, research results that measure the impact of certain shareholder model features—including director independence and the absence of both staggered boards and poison pills—are mixed and provide no clear conclusions about the viability of the model. In fact, the D.C. Circuit Court of Appeals overturned a proxy access rule, which gave some shareholders the right to use corporate funds to wage proxy battles, because the body of research available provided such ambiguous results (Stout 2012).

### Workers

The 1980s takeover market not only weakened managerial power to make long-term strategic decisions, but also decimated labor power as hostile takeovers typically led to widespread job loss.<sup>15</sup> More broadly, in every effort to minimize labor costs, shareholder primacy has pulled the loose threads of welfare capitalism, unraveling the pension and health benefits that Americans had taken for granted and that, in contrast, European governments provided.

As the shareholder model put pressure on union power and undermined worker interests, unions had to shift their strategy. When the takeover market was active in the 1980s, the unions aligned with management to try to institute anti-takeover mechanisms both within companies and through state laws. Management, however, did not reciprocate the loyalty and unions ultimately abandoned this strategy in favor of advocating for worker interests through shareholder activism via union pension funds (Peterson 2015).

### **The German Corporate Governance Model: From World War II to the 1990s**

The German model is often considered the paradigmatic stakeholder model and is most known for the

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<sup>14</sup> Analysts often treat buybacks as a stand-alone issue, but there is compelling research that suggests one of the main reasons companies conduct stock buybacks is to offset their executive compensation packages. For example, Klassen and Sivakumar’s (2001) research looks at repurchase and option activity for nonfinancial firms from 1995 to 1999. Their findings indicate that firms repurchase shares particularly to avoid dilution from executive stock option compensation programs. Further, Griffin and Zhu’s (2009) research states that “we conclude that the popular use of buybacks as a form of cash distribution derives significantly from a strong contemporaneous relation between stock buybacks and CEOs’ use of stock options as compensation.” However, Weisbenner (2000) finds that for 1995 repurchase activity, overall firm options rather than executive options, are connected with repurchase activity. Whether or not offsetting pay is the sole reason companies conduct share repurchases, we can be sure that without buybacks, companies could not structure compensation so heavily with stock grants and options.

<sup>15</sup> Vishny et al. (1990) examined all hostile takeovers from 1984 to 1986 that entailed a purchasing price of \$50 million or more. Twenty-one of the targets experienced layoffs. The average number of layoffs among the firms was 1,262 employees, or almost 6 percent, while the number laid off spans between 120 and 6,148, or between 0.1 percent and over 24 percent of the labor force of the target firm. The authors also found that the fraction of the takeover premium layoffs explained by layoffs “is highest for targets of successful takeovers—37.9 percent, compared with 16.8 percent for firms acquired by white knights, and 26.6 percent for firms that remained independent.”

strong relationship companies have had with banks and for its co-determination system. The banks' close relationship with German companies has its roots in the late 19<sup>th</sup> century when, in 1871, Germany both unified and won the French-Prussian war. Business quickly boomed using French reparation funds, but the ensuing 1873 stock market crash—the *Gründerkrise*—rendered the capital markets anemic. Without developed stock and bond markets, the banks, like the newly formed Deutsche bank and Commerzbank, were the primary source of capital and enabled family firms and new industries to grow into industrial powerhouses (Dignam and Galanis 2009).

While co-determination also has antecedents in the 19<sup>th</sup> century and advanced during the Weimar Republic, the weakened political power and moral authority of German companies that cooperated with the Third Reich made it possible to implement a more comprehensive version of co-determination in the early 1950s (McGaughey 2015; Borsch 2007).

Close to 20 European countries have some form of co-determination in place, but the German version is the most extensive; it is deeply rooted in workplace culture and well supported by public opinion. It was instituted with an explicit focus on creating a democratic decision-making process at the workplace and equalizing the power of workers and capital. It was also designed to reward employee loyalty and make human capital a profitable investment (the latter similar to the logic of American welfare capitalism) (Berger and Vaccarino 2016).

Germany's accelerating productivity and industrial might—a.k.a. the German “economic miracle”—during this period was the result of many factors and is a considerable topic of debate. For the first two decades after World War II, with the help of the Marshall Plan, German productivity caught up to earlier trends through reconstruction efforts and as workers were leaving less productive industries like agriculture (Ritschl 2004). Some economists argue, for example, that ending price controls, eliminating the food rationing system, and lowering top marginal tax rates all boosted incentives to increase supply (Henderson 2008).

Historians of Germany's economy are apt to point out that beyond any macroeconomic factors, the country's economic transformation can be understood in terms of the dynamics of corporate decision-making, including the industrial relations between workers, management, boards, and shareholders. These institutional arrangements “provided the foundations for a workable system which performed extremely well for most of the post-war era and has achieved and maintained a high level of social welfare and cohesion” (Dignam and Galanis 2009).<sup>16</sup>

### Workers

Co-determination engages worker participation in management decision-making through two mechanisms: employee representation on boards and works councils. German law requires that, depending on a company's sector and size in terms of employment, up to half of the supervisory board

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<sup>16</sup> For an in-depth history and analysis of Germany's co-determination system (in English), see Silvia (2013).



members are employee representatives rather than shareholders.<sup>17</sup> Further, in Germany, unlike the U.S., union bargaining typically happens at the national level while a works council, or *Betriebsrat*, is the “shop floor” organization that represents workers and implements labor law at the local level. Works councils address work-place issues, such as shift times, overtime, and rest periods, monitoring programs, the introduction of new technology, and significant layoffs. Works councils are said to be essential for communicating information from the shop floor to the boardroom, and some even argue that they are more influential on labor-management relations than worker representation on boards when it comes to employees’ everyday experience at work (Prenting 1992).

### Shareholders

The nature of share ownership was another unique aspect of German corporate governance during this era. Like most stakeholder models, Germany had very concentrated ownership shares. What was different was that German banks were major blockholders as well as creditors.<sup>18</sup> The fact that banks and companies held this close “*Hausbank*” relationship meant that they had in-depth knowledge of the internal strategies and dynamics of these businesses. This fostered “patient capital” (i.e. low-interest, long-term credit) that minimized corporations’ stock market exposure and thereby offered corporations substantial cover from the pressure of short-term oriented foreign investors and fended off hostile takeovers, enabling management to take the long-view.

Another unique shareholder pattern were the dense cross-firm networks that developed as businesses increasingly built up their ownership shares in each other. Sometimes these relationships would serve as alternative sources of finance in lieu of bank loans and offered additional protection from capital market exposure (Borsch 2007).

### Boards

German boards have a two-tier structure: a management committee (*Vorstand*) for day-to-day functions and a supervisory board (*Aufsichtsrat*) for more high-level decisions (akin to U.S. boards). Board level co-determination gives employees representation on supervisory boards, which have more power as they make more strategic decisions, including investment decisions and selection of top management (Prenting 1992). Per German law, shareholders make up the rest of the supervisory board (Silvia 2013). Subordinate to the supervisory board, the management committee, comprised of senior executives, has considerable security, which is meant to ensure that they have autonomy and power in their management decisions (Charkham 1994). We will discuss the impact of this board structure later in the paper.

### Managers

True to stakeholder capitalism, the career path of the typical German CEOs developed mostly within one firm, which arguably shaped their focus on productivity improvements and cost reduction in lieu of shareholder value and quarterly profits. Similar to the U.S. system pre-1980s, managers had significant

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<sup>17</sup> In companies with fewer than 500 employees, there is no requirement to have worker board representation.

<sup>18</sup> Blockholders are owners of large concentrations of shares and/or bonds.





leeway and autonomy in setting strategy and were very cognizant of the pressures that employee interests exerted, as well as the interests of other stakeholders, particularly banks and other companies. Executive pay was also relatively modest. For example, in the 1970s and early 1980s, executive pay was either flat or falling and then rose by about 4 percent a year until the early 1990s (Fabbri and Marin 2012; Conyon and Schwalbach 2000).

### **German Corporate Governance: 1990s to Today**

From its post-war recovery through the 1980s, the German model was envied for producing quality products, creating jobs, and generally solid economic growth. Yet, as Asian countries, particularly Japan and Korea, began competing with German companies at the same quality level, Germany experienced lower sales margins and lost leverage in their export markets. German reunification in 1990 and the reintroduction of capitalism to East Germany strained the German economy.<sup>19</sup> In 1993, Germany had its longest recession since World War II, and unemployment in some regions of the country reached 50 percent (Dignam and Galanis 2009).

Germany responded by, amongst other policies, modernizing its financial system in the 1990s. The central goal was to expand the equity and money markets to make Germany competitive on the global stage. Many predicted that this would lead to shareholder convergence, particularly due to the pressures from short-term oriented shareholders to dismantle the co-determination system. Yet, co-determination, while not without a few scratches, has remained intact, as has the broader culture of German corporate governance defined by both its treatment to workers as stakeholders and to its commitment to long-term growth over next-quarter returns.

### Workers

While many employers have remained supportive of co-determination, during the 1980s and in the 2000s, some pushed to weaken the role of workers on boards, but they never garnered enough political support. Trade union officials, along with their supporters, have been successful in pressuring both the Schroeder and Merkel governments to enact reforms that shored up both types of co-determination. In 2006, Chancellor Merkel unequivocally showed her support by stating “co-determination is part of our social market economy, which is impossible to imagine doing without, and which has proved itself in Germany.” In 2009, she enacted the reforms recommended by Chancellor Schroeder’s commission on co-determination (“the second *Biedenkopf* commission”) that were largely seen as a win for labor (Silvia 2013).

The continued strength of co-determination is evident in the numbers. Under the 1976 Employee Co-Determination Act, arguably the most consequential piece of co-determination legislation,<sup>20</sup> the number of firms that are included rose from 475 in 1977 to 573 in 1991. In 1992, due to German unification, the number jumped to 709. The number of enterprises included by the law peaked at 767 in 2002 and settled

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<sup>19</sup> Between 1991 and 2010, western Germany transferred \$1.8 trillion, or roughly \$5,000 per person per year, to eastern Germany. This is the largest per capita wealth transfer ever (Silvia 2013).

<sup>20</sup> The Employee Co-Determination Act (*Gesetz über die Mitbestimmung der Arbeitnehmer*) mandated that all companies (outside of coal, iron, and steel industries, which have their own co-determination law) share supervisory board seats equally between shareholders and employees.





at 681 in 2010. More than 5,000 workers, including over 1,700 union officials, serve on supervisory boards. Further, due to 2001 reforms, which expanded the definition of workplace employee to cover temporary workers and employees of subcontractors, the number of workers employed at companies with works councils rose from 40 percent in 1994 to 44 percent in 2009 (Silvia 2013).

### Shareholders

The most fundamental change to German corporate governance is to shareholders' role and power. In response to a range of reforms, the role of banks as blockholders and creditors has declined, ownership concentration has fallen somewhat, cross-company networks have begun to dissipate, and foreign investors, particularly hedge funds who tend to favor short-termism, are an increasing presence as activist investors (Grumberg et al. 2016).

Yet, the literature also indicates that activist pressure has not been an overbearing presence, because there is enough "patient capital" available in the form of public financing and through the remaining involvement of "anchor investors,"<sup>21</sup> who generally favor long-term strategies over maximizing quarterly returns. Furthermore, according to Deeg, "for those relatively small number of large German firms where institutional shareholders have become collectively significant (if not the majority) as owners, their general passivity has arguably increased rather than decreased managerial autonomy."

### Boards

Management boards have changed somewhat with the increased presence of investors, though there doesn't appear to be much tangible pressure on their behalf to shift gears from a long-term to next-quarter strategy. The higher level supervisory boards have maintained their same composition, including the strong presence of worker representatives.

The recent Volkswagen (VW) emissions scandal has once again called attention to the German system, particularly to the role of supervisory boards in these scandals. Some analysts blamed the board structure of co-determination and called for its demise because "labour representatives can sometimes become too closely aligned with corporate interests and end up conniving with management at the expense of the workers" (Chazan 2016). There is no evidence, however, that employee representatives on the VW supervisory board were aware of the diesel scandal until it became public. Furthermore, this accusation loses sight of the fact that the shareholder model has also led to a spate of scandals and crises, including its role in the global financial crisis. Perhaps the broader point is that corporate systems can get entrenched by power relationships, with or without workers serving on them, which suggests reforms that target these distorted power dynamics.<sup>22</sup>

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<sup>21</sup> Shareholders who generally own 25 percent or more of corporate shares.

<sup>22</sup> One example would be to place limits on how long a worker can serve on a works council, preventing any one worker from developing a "co-determination career" and thereby losing contact with rank and file workers. Furthermore, these kinds of events are another argument for adding more diversity to corporate boards as it disbands the typical old boys clubs (Rhode and Packel 2014). Of course, an essential point of reform comes from the enforcement of laws. Being willing to put board members in jail for breaking the law, which rarely happens in the U.S., would serve to uphold good corporate governance practices. We can talk about internal rule configurations ad nauseum, but if the external rules are not properly upheld through investigation and prosecution by the criminal justice system, common debates about how to structure boards so that board members behave are pointless.

## Managers

Patterns in executive pay are another indication that the German stakeholder model is staying true to form. While the Supervision and Transparency in the Corporate Sector Act (KonTraG), the suite of corporate governance reforms instituted in 1998, made executive stock options much easier and less expensive to implement, executive stock options have generally remained controversial and are viewed by the public as a highly suspect practice, which has led many companies to abandon it. “Owing to diverse scandals, the dubious connection between stock options and company performance, and most important, to new international regulations, management compensation through stock options has fallen out of fashion” (Borsch 2007, 178). As a result, the use of options is relatively limited compared to the U.S. While stock options comprise almost 63 percent of the average CEO pay package in America, they make up only 24 percent of German CEO pay (Equilar 2016). Furthermore, while German executive pay has risen, it is nowhere near the levels of America’s juiced up executive pay. In 2015, the typical German CEO made \$5.6 million while the U.S. counterpart took home \$14.9 million (Equilar 2016).

In addition, the German sense of executive strategy and purpose remains intact. In a recent ethnographic study of executives in Germany and Japan, Witt and Redding (2009) demonstrate that Germany’s characteristic notions of company purpose have stayed in place. While we know from studies, such as Graham et al. (2004), that U.S. executives generally subscribe to shareholder value thinking, German executives, as revealed by Witt and Redding, emphasize the importance of serving society and balancing the interests of shareholders and employees through the production of quality goods and services.

## **Comparing Corporate Governance Systems**

What is striking about this comparison between the U.S. and German systems is that they both started out with features of stakeholder capitalism, albeit Germany’s had much more so. They both had relatively powerful managers who were committed to long-term growth and paid relatively modest salaries to their executives. Both also valued workers as essential stakeholders of the firm.

The broad differences are twofold: First, widely dispersed shareholders in the U.S. were relatively powerless and content to passively receive their dividend payments, whereas German shareholders were largely banks and other companies who held large concentrations of stock and provided “slow credit” which fostered a long-term focus and fended off takeovers. And second, Germany had the strongest co-determination system in Europe, whereas the U.S. has no such system.

In the 1980s, shareholder primacy manifested in the U.S. in the form of skyrocketing executive pay, the heavy use of stock buybacks, a decline in corporate investment (including investment in jobs), rising inequality, and a hyperfocus on quarterly returns at the expense of long-term corporate and economic growth.

Germany, in its attempt to expand its small capital markets and adapt to the pressures of capital



liberalization, deregulated stock options and buybacks, and there was indeed a rise in use. Yet, many companies have taken a much more measured approach to these tools and remain committed to their long-term strategy and the notion of a stakeholder system.

## ***The Power of Co-Determination***

It's always difficult to determine exact causality in broad, complicated systems, and assigning causation to how and why Germany's corporate governance regime has shielded itself from full throttle shareholder primacy is no different. For example, Borsch (2007) argues that the resistance to short-term quarterly returns is mostly due to the minimal role stock options play in German executive compensation, which has created such distorted incentives in the U.S. But this does not explain why stock options are not a central feature of German corporate governance.

Our argument is that, without co-determination, both the pressures of short-termism and their outcomes, in particular the heavy use of stock buybacks and excessive equity pay for managers, would be a much stronger force.

First, co-determination is integral to the culture of German corporate governance, in which the value of taking a long-term view is deeply embedded. This is evident from the public support and political pressure policymakers felt as co-determination has been reformed and protected over the decades. The sentiment that co-determination goes hand in hand with their corporate governance system is generally true even for managers, many who passionately resisted reforms that shored up co-determination but have ultimately come to accept it, with some explicitly arguing that co-determination makes the German system better than the British and American regimes (Hildyard 2013).

Second, co-determination is also a source of power with which workers can push back against the pressures of shareholder primacy. This is not to say that there are no other forms of constraint; certainly patient capital still plays a role in holding the power of activist investors in check. But undoubtedly the fact that workers wield board-level power in decisions that range from production strategy to executive pay packages is a significant barrier that buffers companies from this pressure.

### **Why Doesn't the U.S. Have Co-Determination?**

Why did the U.S. never institute co-determination when so many countries in Europe have done so? It is no surprise that corporate managers, who, according to Jacoby (2005), had a paternalistic view of workers, rejected the idea out of hand—but so did many unions. As the president of the Machinist Union put it in the 1970s, “We have no interest in replacing free enterprise with a more utopian system... And we believe workers can receive a better share of free enterprise at bargaining tables than in board rooms.” Lane Kirkland, President of AFL-CIO from 1979 to 1995, also argued that “The American worker is smart enough to know, in his bones, that salvation lies—not in reshuffling the chairs in the board room or the executive suite—but in the growing strength and bargaining power of his own autonomous



organization” (Summers 1982).

In terms of works councils, another explanation for U.S. union resistance is that they operate principally at the workplace level. In Germany, unions operate on the sectoral level (e.g., metalworking) while works councils operate at the workplace level. According to Silvia (2013), this sectoral focus is why works councils don’t displace German unions, but why U.S. unions fear they themselves could be displaced.

It is impossible to know what could have been different in the late 1970s if the U.S. had a co-determination system in place. German workers lost jobs but had a seat at the table in making decisions about these cutbacks. Yet, through unions, so too did U.S. workers until their bargaining leverage was demonstrably weakened as membership waned and the Reagan administration began its union busting campaign. However, as valuable as U.S. workers were to businesses, they were never stakeholders in any meaningful sense.

Two or three decades of co-determination in the U.S. could arguably have had major effects. It could have enhanced labor relations, which would have made for stronger companies and industries. Labor researcher and journalist John P. Hoerr argues the decline of American steel was partly due to the terrible state of relationships between steel workers and management. An obsolete and adversarial relationship between management and labor made it harder for the industry to adapt to structural changes in the global economy. By contrast, the *Kommission Mitbestimmung*, tasked in 1998 with evaluating the worth of Germany’s co-determination system, concluded unanimously that co-determination promoted the “cooperative modernization” of Germany’s firms by deepening trust between management and labor and improving information flow (Silvia 2013).

With workers having decision power on boards, they would likely have created more internal resistance to the notion that shareholders are the only meaningful stakeholder and enhanced a corporate culture that revolved around long-term strategy. An entire generation of workers could have grown up thinking that worker stakeholders were a natural part of the corporate governance system. While Americans are constantly surprised to learn corporations are not legally bound to serve shareholders alone, German workers see stakeholderism as embedded in their DNA.

## **Future Policies**

A point often made in the corporate governance literature—by scholars sensitive to institutional differences—is that it’s not easy to borrow a prominent feature of one model and expect it to work well in an entirely different one. History, culture, and social relations shape a particular path dependence that can make a model resistant to change. It may have been easier to institute co-determination before shareholder primacy took hold, but can it be done now? Should it be done? Is co-determination the right policy to pursue?

In 2014, a union vote at a Chatanooga Volkswagen plant—a German manufacturer employing U.S. workers—made the news because it would have been the first U.S. workplace with a German-style works



council. The plant voted down the union, thus precluding the works council, but it renewed the question of whether co-determination could work in the U.S. Obviously, the VW emissions scandal isn't a selling point, but the co-determination idea seems to keep percolating. In 2016, even then Tory candidate for Prime Minister Theresa May raised the idea of creating a space for workers on U.K. corporate boards, a most unlikely host of co-determination given that U.K. companies represent another prototypical shareholder model (Chazan 2016).

The biggest obstacle to adopting either form of co-determination in the U.S. is still employer resistance, particularly given that the American labor movement does not have the leverage of their German counterpart to push for this legislation. Nevertheless, considering its impact on German workers and the economy, it's worthwhile pursuing in the U.S., at the very least as a rhetorical argument for challenging the dominant model of shareholder primacy and to shed light on how far from a productive and fair model of corporate governance we have drifted.

ESOPs—a form of worker ownership—have also been gaining policy attention recently as a means of redressing wage inequality. According to the National Center for Employee Ownership (NCEO), there are approximately 7,000 ESOPs in the U.S., involving 14 million employees (2017).<sup>23</sup>

According to the NCEO, employee-owned businesses pay 5 to 12 percent more in wages than traditionally owned companies. They have twice the retirement accounts and are only one-quarter as likely to be laid off. The NCEO also claims that ESOPs show higher job growth and that the program brings increased productivity and higher profitability to firms. Economist Jared Bernstein argues that ESOPs are a viable option for redressing inequality:

Shared ownership and ESOPs appear to have a small, equalizing impact on wealth and wage distributions. Since ESOPs transfer capital ownership to workers less likely to own capital, this equalizing impact is expected. But there is no obvious reason why wage distributions in firms with employee ownership should be less varied (more equal) than in other firms. Yet, while the data are only suggestive on this point, I show that as the extent of employee ownership rises, wage inequality among worker-owners declines.

ESOPs would perhaps be better suited in the current U.S. context. They certainly fit within a shareholder-oriented model. Yet, it's important to evaluate whether these programs are building worker power in a way that cannot be easily upended and fosters long-term resilience for the company. ESOPs may incentivize workers to be productive, but they don't necessarily give workers the right to vote their shares and may not offer enough of a countervailing weight to offset the outsized power of other stakeholders in, for example, a merger fight.

There are, of course, other, stronger forms of worker ownership, particularly cooperatives. While ESOPs offer workers a certain amount of ownership shares in a company, cooperatives are business

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<sup>23</sup> Although ESOPs are generally used by private companies, they can apply to public companies as well.



organizations owned and managed entirely by workers.

The right policy and advocacy strategy is likely to elevate all of these ideas simultaneously, while underscoring the point that benefits provided to workers without meaningful stakeholder decision-power will likely not foster a more resilient system for any stakeholders, including workers. At any rate, these questions are worthy of much more discussion and research.

## ***Conclusion***

Perhaps the quote that most brazenly represents American shareholder primacy ideology is from USC Professor Kevin J. Murphy. In 2012, he wrote:

While the pay controversies fueling calls for regulation have touched on legitimate issues concerning executive compensation, the most vocal critics (such as members of labor unions, disgruntled workers and politicians) have been uninvited guests to the table who have had no real stake in the companies being managed and no real interest in creating wealth for company shareholders.

Murphy is expressing an idea that is both unfair and bad for our economy: that workers are not corporate stakeholders and therefore have no businesses expressing their opinions about corporate decisions, including those that so brazenly drive their bosses pay into the stratosphere while stifling their own.

We know from looking at both U.S. history and the German example that we can—and must—reject this mentality that has dominated public discourse about corporations for decades in order to build a more productive, resilient, and prosperous economy for all. Workers especially, who are investing in companies with their own labor on a daily basis, have a legitimate claim as corporate stakeholders, and it will serve companies, and society more broadly, if we—on the left at least—felt empowered enough to stake this claim.





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