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## Multinationals and the Rise of Variable Pay in Germany

**ABSTRACT** ■ This article examines the use of variable pay in large German companies. It is shown that the implementation of contingent pay has increased, in spite of institutional constraints deriving from the German system of industrial relations. The increase can be explained by the growing internationalization of product and capital markets as it is the multinational companies with a high percentage of foreign sales and a strong orientation toward shareholder value that are most likely to use flexible pay. Unions and works councils are not excluded from, but are actively involved in, these changes. Hence, the trend toward decentralization and flexibility of remuneration schemes indicates a change toward a more Anglo-American business system, but also reveals the strong embeddedness of German companies in the German system of industrial relations.

### Introduction

Remuneration practices that link workers' pay more closely to individual and company performance<sup>1</sup> have become more popular in Germany since the mid-1990s. This is regarded as one indicator of the ongoing decentralization of the German system of industrial relations (Katz and Darbishire, 2000). This system is based on two prominent features: centralized and coordinated collective bargaining, and codetermination at enterprise level. The low dispersion of wages between individuals, industrial sectors, and large and small firms is mainly due to the centralized system of collective bargaining, promoting solidarity and union strength (Lane, 2000; Streeck, 1997). Hence, the lack of individualized wage components and remuneration schemes that tie a worker's income to the fortunes of the enterprise (compared to countries such as the USA, Great Britain or France) is partly attributable to the heavily institutionalized, cooperative and codeterminative German industrial relations system with its strong trade unions and works councils, which successfully oppose variable pay schemes and increasing wage dispersion.

In the literature, it is widely argued that globalization has put the system of employment relations under severe pressure. As Thelen and van Wijnbergen (2000: 2) put it:

According to the prevailing wisdom, increased capital mobility and high unemployment have shifted the power decisively toward employers, who have used this power to embark on a broad, neoliberal offensive—against ‘rigid’ uniform (centralized) regulations in favour of more flexible (decentralized) bargaining that can accommodate the different needs of individual firms and plants.

Given that the system of industrial relations may be regarded as an important institutional influence on the broader national business system (for example, Lane, 1992), or indeed an integral component of the national business system (for example, Lane, 2000), the trend toward variable pay may be expected to have an impact on the German business system as a whole.

In examining large companies in Germany, among them several subsidiaries of foreign firms and many German-based multinational companies (MNCs), this article explores to what extent and in which ways flexible payment systems are implemented in German companies. The focus will be on the role of foreign subsidiaries and German MNCs in explaining the shift toward variable pay. The internationalization of product and capital markets as well as the expected constraints imposed by the German industrial relations system are also taken into consideration in examining the way in which German companies react to the increasing tensions between internationalization and national embeddedness.

## Variable Pay as a Human Resource Management Device

Performance management is one of the key issues in human resource management (HRM). The current interest in variable pay is based on the assumption that financial rewards provide strong incentives to work harder or better, or both. Hence pay schemes are seen as an important tool of performance management.

Variable pay includes all wage components that are contingent either on a *firm's performance* (or the performance of units within the firm), such as profit-sharing, annual bonuses or employee ownership plans, or on *individual workers' achievements* (that is, performance-related pay), ranging from traditional piecework to different systems of reward linked to appraisal and income-relevant forms of management by objectives. Two dimensions of growing pay flexibility are considered: flexibility over time and flexibility across individuals. In contrast to many other studies dealing with flexible remuneration systems, the focus is exclusively on

pay systems for non-managerial employees covered by collective agreements.

Individual performance-related pay is supposed to help focus employees' effort on their key job objectives and to clarify the links with business goals so that the enterprise may benefit from the congruence of worker and company objectives. Furthermore, merit pay is aimed at giving greater recognition to outstanding performers to enhance the incentive for productive behaviour. Linking employees' pay more closely to company performance is supposed to encourage them to identify with and feel committed to the company. They start to think about generating revenue, reducing costs and maximizing profit, which stimulates entrepreneurial decision-making. This leads to the alignment of employee and shareholder interests, helping to attract new shareholders and reduce the conflict between the two groups, since shareholders are no longer the only ones to benefit directly from profits worked for by employees.

A special form of participating in the company's success, and a way of bringing shareholders' and employees' interests closer together, is the introduction of employee share-ownership plans or share options. Since the jobholder has hardly any influence on the share price, the link between individual performance and financial reward is less direct than in the case of merit pay, profit-sharing or other annual bonuses; therefore, the motivational qualities of shares are limited. The advantages are the long-term character of an incentive that binds employees to their company, and the alignment of shareholder and employee interests.

Besides motivational and productivity-related aspects, variable pay also increases the flexibility of business cost structures. When profits are high, compensation will be higher than without variable pay and comparably lower when business is weak. Employees have to accept some risk to share in the rewards of improved performance. Furthermore, managers expect a positive cost effect because of increased productivity or at least better cost control. Flexible remuneration schemes thus fulfil functions not only of performance enhancement, but also of financial management.

## **Variable Pay in Large German Companies**

A decade ago, David Shonfield (1992: 169) wrote of variable pay in Germany that there was 'in general far less concern about the relationship between company pay determination and economic performance than in France or Italy, let alone the obsession that there is in Britain'. He reported 'hardly any interest in profit sharing' and no sign of large firms promoting substantial modifications of existing pay systems. Kirsten Wever (1995: 614) compared German and US-owned chemical companies in Germany and observed that 'in the US-owned firms compensation

tends to be linked to individual performance. . . . Performance appraisals are frequent and strongly emphasize individual achievement. . . . Employee development through individual goal setting techniques had been introduced in the early 1990s', whereas in German-owned companies 'compensation tends not to be performance-based except for higher-level managers'.

In the USA, the trend toward variable pay seems to be unbroken and accelerating (Lebow et al., 1999). However, international comparisons of pay systems are rare and, due to the huge heterogeneity of remuneration schemes, difficult to conduct. Most studies include, or even focus on, managerial pay, where flexibility is more widespread than at shop-floor level. Others focus on either performance-related or profit-related schemes (see, for example, Commission of the European Communities, 1996; Filella and Hegewisch, 1994; Harges and Wickert, 2000). Reviews covering all staff and all forms of variable pay are less common. Still, there seems to be consensus that variable pay originates in Anglo-Saxon business cultures and does not fit neatly into the German framework of employment relations. Before turning to the empirical evidence of the remarkable shift in the remuneration systems of German companies that started about five years ago, I will consider the potential constraints that were often given as an explanation for the modest use of variable pay in Germany.

### **Institutional Constraints**

Two prominent features of the German industrial relations system (collective bargaining and works-level codetermination) play an important role in relation to variable pay. Regional industry-level collective agreements between unions and employers' associations determine wage levels. Collectively bargained wages usually account for at least 90 percent of actual pay. In determining the predominant part of a company's wage bill, the collective agreement indirectly sets the budget available for variable pay or company-specific bonuses, that is, wage drift. These additional payments above the union wage rate used to be set by management or negotiated between management and the works council, and distributed equally (relative to income) to all employees.

Unlike collective agreements, pay systems do not determine the wage *level*, but regulate how payments should be distributed among employees. Traditionally, performance-related pay schemes were based on quantitative measures of employee performance (piece rates); as such, they were subject to collective bargaining.

Most collective agreements establish only loose principles for payment systems or none at all (an overview is given in Bispinck, 2000). Unless regulated collectively, the principles of remuneration and the introduction and application of new remuneration methods are, under the Works

Constitution Act, issues of codetermination and negotiation between employers and works councils. The results are mostly set out in works agreements.

Where employers wish to impose flexible forms of remuneration unilaterally, unions and works councils opposed to such schemes, which potentially increase wage dispersion among individuals and firms, can prevent them from doing so. Unions and collective negotiations serve to enhance workers' influence on wage determination and to prevent the arbitrary use of power by employers, whereas remuneration schemes that are based on individual differentiation between workers or firms undermine this function and remove a primary justification for a union presence (Gunnigle et al., 1997: 137–8). Thus, handing over responsibility for merit pay to works councils or management might discourage unionization (Heywood et al., 1998: 238). Moreover, works councils oppose variable pay because of its flexibility over time, and because workers do not want to run the risk of losing income due to managerial mistakes or economic downturn.

Muller (1999) carried out case-study research in 1994 on the introduction of different human resource management policies, including variable pay, in firms located in Germany. He reports that firms found their managerial autonomy constrained by the institutional context. In one, 'employee representatives completely resisted attempts by management to change an existing fixed-bonus system into a performance related one' (Muller, 1999: 38). Whether this 'lack' of variable pay holds true for the late 1990s will now be examined for a bigger sample of large companies in Germany.

### **Variable Pay in Large Companies in Germany: Research Methods**

The unit of analysis is a sample of 114 large companies located in Germany. This sample contains all companies from the top-100 rankings compiled by the German monopolies authority (*Monopolkommission*) for 1986 and 1996 that still existed in the year 2000.<sup>2</sup> The rankings are on the basis of net value added in Germany. In all, 17 of the companies are foreign-owned; 30 of the remaining 97 companies employ less than 5 percent of their workforce abroad, whereas 42 companies employ more than 30 percent in foreign subsidiaries (for further details on the degree of internationalization, see Hassel et al., 2000). This sample is not representative for the German economy as a whole. Nevertheless, the 100 largest companies in 1996 employed 3.7 million in Germany in 1996, that is, about 16 percent of all private-sector employees. They contributed nearly 18 percent of gross national product in the private sector (*Monopolkommission*, 1998: 173–5). The sample comprises 64 companies from manufacturing and 50 from services. The manufacturing companies

come from engineering and electronics (34), chemicals and pharmaceuticals (18), food products (7), and construction (5). The service-sector firms cover utilities (12), retail (11), banks (10), insurance companies (8), and others (9). An advantage of this sample is that it includes 'flagship' companies from the core industries that influence the behaviour of other, smaller companies. These large companies also hold dominant positions in employers' associations. Hence, this is where changes in the fields of collective bargaining and codetermination can be observed at an early stage.

The research was conducted in 2000 and 2001 using a pluralist approach involving qualitative semi-structured interviews with personnel managers and members of the central or group works council, a questionnaire-based survey completed by works council members, and analysis of documentary evidence.

The questionnaire was filled in by 78 of the 114 companies. Rather general questions were asked about the existence of performance- or profit-related pay and employee share-ownership programmes. Respondents were also asked when such pay systems had been introduced, whether the variable income share had decreased or increased, and whether it was based on industry collective agreements or on company agreements. Where variable pay components were present, and especially where they had been introduced recently, additional telephone or face-to-face interviews were held.

Interviews were conducted with 43 works councillors and 16 corporate-level personnel managers, covering 55 companies. Some 9 of the works councillors were from German subsidiaries of foreign-owned firms. The personnel managers were responsible for remuneration at the German sites only. In these interviews, the payment systems and the circumstances of their implementation were discussed in greater detail.

The approach to personnel managers and works councillors at the top of the company or group meant that at the aggregate level only broad questions concerning the existence of flexible wage components could be asked. More detailed information about the characteristics of the remuneration system was obtained where the new payment system was introduced company-wide. In a few cases, groups with independent companies (independent that is in terms of their remuneration system) were split and information was gathered at company level. As a result of this approach, there might be a bias toward centrally implemented variable pay and toward more extensive changes. In 52 percent of responding companies the payment system was centrally implemented. In all, 75 percent of all companies with profit-related pay and 70 percent of all companies with performance-related pay reported having implemented it throughout the company. The remaining 25–30 percent named individual units where variable pay had been introduced and these units were

contacted subsequently. A general trend toward decentralizing remuneration decisions to lower levels of the firm could not be found. The survey may not capture every single form of variable pay implemented in a small enterprise of a large group, but the primary interest here is in the broad pattern of change in remuneration practices.

Additional information was gathered through documentary evidence, including press reports, annual reports, companies' websites, and internal publications such as newsletters or works agreements. In all, comprehensive information was collected on the payment systems of 90 companies. The remaining 24 cases are missing data.

## Empirical Findings

*Performance-Related Pay* Seventy percent of the companies for which data exist currently use some form of performance-related pay. Of these, 48 percent have extended merit pay recently (see Table 1) and 65 percent pay productivity bonuses above the collectively agreed wage. In 35 percent, performance-related pay is regulated by a collective agreement; with very few exceptions, these companies either belong to the engineering sector or are not covered by an industry-level agreement. Moreover, interviews reveal that performance-related pay regulated by industry-level agreements in the engineering sector, whether piecework or a system of appraisal, is not really flexible and the term 'performance-related' is misleading. Downgrading hardly exists and bonuses are often consolidated. About a third of all performance-related systems are of this kind. However, almost 40 percent of companies have begun to use individual target setting, linked to financial rewards.

*Profit-Related Pay* Wage components that are linked to company performance are found in slightly more than half the companies (see Table 1). In 15 percent of these, the size of the annual bonus is set unilaterally by management; in 25 percent, management and the works council negotiate it; and the remaining 60 percent calculate the size of the bonus using a formula based on economic indicators such as return on capital employed, pre-tax earnings, return on investment, the dividend, or a combination of factors. Whether these figures refer to overall company results or those of individual business units is only clear in 17 cases. Of these, 11 companies use central reference numbers, 4 use the results of company units, and 2 use a mixture of both.

*Employee Share Ownership* Some form of financial participation is offered by 57 percent of companies (see Table 1). Many of these have a long tradition of employee share ownership: about 30 percent of programmes started between 1962 and 1977. The traditional plan offers



TABLE 1. Extent of Variable Pay Systems

Pay system	Number of companies using pay system	Number of companies in which the system was recently introduced or extended
Performance-related pay	63	30
Profit-related pay	46	18
Employee share ownership	51	20

*N* = 90.

financial incentives in the form of a small tax-free premium (DM300) paid by the firm, combined with tight limits on the value of shares available. Today, 52 percent of plans offer more shares and innovative financial incentives exceeding the usual tax-free premium. Most have been introduced since 1997. Also, five companies offer share options to all their employees. Some firms distribute shares instead of cash payments as bonuses. Shares are thus gaining importance as an element of remuneration. Nevertheless, the proportion of company capital owned by employees barely reaches the 2 percent mark in most of the companies. Compared with employee ownership rates in the USA, for example, this is a negligible proportion.<sup>3</sup>

*The Variety of Variable Pay: Compensation Schemes in More Detail*  
 These findings are broadly consistent with evidence from other studies (for example, Bahnmüller, 1999, which used a larger and more representative sample, Bispinck, 2001, and Franz et al., 2000). Nevertheless, aggregate numbers do not adequately reflect the shift in compensation practices currently taking place in Germany, especially since it is difficult to distinguish between traditional and new variable schemes. The following remarks refer to about 30 companies that have moved toward greater flexibility in their remuneration schemes. Either they have changed to variable pay recently or have enhanced existing schemes by increasing the percentage of variable pay or by using more elaborate performance appraisal or profit-related systems.

Since 1994, 22 of the 114 companies have introduced flexible wage components or rearranged company-specific payments in a completely new contingent way (see Table 2). A few firms introduced company-wide bonuses from the outset because profits were high. Everyone receives payments if the company achieves specified business goals. These 'on-top payments' are rather rare. Most companies have financed new remuneration schemes by removing, at least partially, formerly fixed wage components in order to distribute performance-related payments. In these

TABLE 2. Companies Implementing or Extending Variable Pay Since 1994

Year of change	Company
1994	IBM Deutschland GmbH
1995	Hoechst AG, BMW AG, Lufthansa AG, Bayerische Vereinsbank AG
1996	Beiersdorf AG, Dt. Telekom AG, Henkel KgaA, Commerzbank AG
1997	Bewag AG, Daimler-Benz AG, Merck KgaA, Schering AG, Wacker-Chemie GmbH
1998	BfG-Bank AG, Metallgesellschaft AG
1999	Audi AG, DaimlerChrysler Aerospace AG, Debis AG
2000	Alcatel SEL AG, Bayer AG, Degussa-Huels AG

cases, it is difficult to assess who actually pays for the new system, the company or the employees. Personnel managers and works councillors of the same company often disagree on this point. In most cases, the implementation of a new scheme is accompanied by a guarantee to maintain current income. In the future, some will be better off and others worse off.

However, the majority of variable pay schemes are introduced to (re)gain control over personnel costs or even to cut costs. Additional costs are to be avoided, or at least offset by productivity gains. Piece rates, on the other hand, often generate high ongoing costs and have mostly been subject to negotiations with the unions, so that the unions could use negotiation of piece rates to achieve wage increases. Today, cost control is often implemented by using budgets to determine the sum available for distribution, either set in advance as a percentage of the wage bill in terms of industry rates or depending on the performance of the company.

For example, one chemical company distributes 10 percent of the wage bill as a budget for performance-related bonuses when a certain level of cash flow is achieved. The percentage will be smaller if cash flow is lower and larger if cash flow is higher. At the same time, management assesses the performance of every employee. Employees whose performance equals the average of all assessment results for that year receive a certain percentage of their base income as a bonus. With the average assessment as the reference point, all other employees receive bonuses according to their individual performance in relation to the average performance. While the company does not run the risk of paying bonuses that do not conform to its business situation, the individual employee runs a higher risk. The size of the premium does not directly depend on actual performance, but rather on the performance of the company and the employee's achievements relative to the achievements of colleagues. Thus workers do

not know in advance how much they will be paid for achieving a given level of performance.

Where formulas are laid down for determining individual rewards, some element of discretion is often left to the manager to decide whether the amount derived from the formula should be increased or reduced. Other remuneration schemes include two independent bonuses: one based on individual performance and the other on the performance of the company. As far as company-wide bonuses are concerned, only one company directly distributes a proportion of its profit. Most use a formula to calculate payments depending on the company's attainment of specified business goals. The usual approach is to distribute similar percentages of employees' salaries. Only in a few cases is the same cash amount paid to every worker.

Given the huge variety of potential forms of variable pay and their combination, it comes as no surprise that heterogeneity prevails. Within the sample, chemical companies and banks appear to favour flexible pay systems the most. Flexible pay also prevails in the IT sector, represented by IBM and SAP as well as by smaller companies that form part of large groups (for example, Debis and Infineon). Chemical companies often tie individual performance-related bonuses to company performance. By linking personnel costs to overall performance (generally using central business numbers) they emphasize the cost-control aspect. Banks emphasize the incentive function of performance-related pay, as a form of remuneration that is completely new in this sector. The total budget for performance-related pay is not independent of the bank's performance, but its exact amount is left to the discretion of management. Often, it is split into separate profit-related budgets for smaller business units or profit centres. In the engineering sector, especially in car manufacturing, new forms of profit-sharing have been widely introduced. As far as performance-related pay is concerned, the industry seems to be constrained by collective agreements. Companies are waiting for collective agreements to change instead of using any leeway that might exist. At sectoral level within engineering, profit-related pay is the main point of discussion, with employers' associations calling for more flexible agreements to substitute profit-related elements for currently fixed payments.

The range between the lowest and the highest attainable bonus differs widely across companies. Moreover, in some schemes even employees who do not meet expectations can expect at least a modest payment, while others include bonuses that are barely attainable. Some schemes limit the amount of upgrading or downgrading from one year to the next, while others restrain wage dispersion between workers. Thus the flexibility of income across individuals or for individuals over time set by these schemes differs widely between companies. Still, the risk of losing pay is real.

Data on actual payouts and wage dispersion were virtually unobtainable. To give an indication, annual performance-related pay can reach up to 150 percent of a month's pay packet. Profit-related pay reaches on average one month's income, sometimes as much as two. These correspond with the size of contingent wage components of new variable pay schemes such as those introduced at Debis, Infineon (planned) or mg technologies: up to 10 percent of annual income is performance related, so an employee who achieves the best results gets 10 percent more than the one who does not meet targets; a further 10 percent is in the form of profit-related bonuses, with the income of every employee rising by up to 10 percent in a profitable year.

### **Why are German Firms Increasingly Implementing Variable Payment Schemes?**

As variable pay is obviously on the agenda of many large companies in Germany, the next step is to search for explanations. The focus is on explanatory factors in the field of internationalization (of product as well as of financial markets) and on the industrial relations system. The dependent variable is whether a company uses variable pay for non-managerial employees.

### **Foreign Companies as Role Models in Germany**

Considering that variable pay was introduced earlier in countries such as the USA, France, Italy or Great Britain than in Germany, one could assume that companies of foreign origin might introduce contingent pay in their German subsidiaries. Although there are only 17 subsidiaries of foreign companies in the sample, some statements can be made. Remuneration in foreign-owned firms as a group seems every bit as heterogeneous as in their German competitors. On closer inspection, and supporting Ferner and Quintanilla's analysis (1997: 92), American firms are most likely to introduce variable pay, more or less successfully.

IBM was one of the first companies to introduce various forms of flexible pay. In 1992, it abandoned (except in its manufacturing operation) the collective agreement with IG-Metall to be able to implement performance- and profit-related pay without having to make large wage increases. The works councillors of two further American companies complained that the American management was trying to introduce new forms of remuneration unilaterally without considering the right of codetermination. This is confirmed by the study carried out by Wever (1995: 617). Sometimes management withdrew its plans as soon as the works council announced negotiations. On other issues either the works council gave

up its legal right to intervene or the action of the management was followed by negotiations. In one company, a member of the works council was mainly concerned about the arbitrary nature of the suggested merit pay scheme. The company did not want to establish any rules, but instead wished to distribute awards on the basis of (arbitrary) appraisal by managers. Another works council member, this time of a French-owned insurance company, said that their management would like them to introduce merit pay, which according to the company was usual practice in France. However, the works council had so far been able to resist the pressure easily, claiming that in Germany the case is different.

Ultimately, the evidence is mixed. These few examples show that the German system of industrial relations can indeed be a constraint on the introduction of variable pay. Nevertheless, the implementation of foreign payment principles is not impossible, as the study by Wever, the example of IBM, and the current increase in variable pay show. However, with regards to the sample, foreign firms do not remunerate their employees in a more flexible manner than German companies, and except for IBM, there is only weak evidence that foreign firms have been the ones to introduce variable pay to German companies through diffusion or dissemination.

### **Increasing Internationalization and the Role of MNCs**

At first glance, the same seems to be the case for German MNCs and the impact of their subsidiaries abroad on German sites. Different managers are responsible for international and national compensation issues and do not interact very closely. International influences on payment systems were discussed with several personnel managers responsible for German sites. Even in companies where flexible pay was introduced, personnel managers reported that they conformed to the circumstances in Germany without input from abroad. They had their roots in Germany where their company had become successful, so why should they disregard the German status quo? They had to comply with German law, collective bargaining and codetermination, and they simply did so. Some claimed not even to know about the payment systems of their foreign subsidiaries.

An example of a company where there seems to be some influence from sites abroad is Daimler-Chrysler. The high bonuses of employees at Chrysler and the changed situation after the merger with Daimler stimulated the German works council to rethink the formula for calculating annual bonuses. However, the real shift had taken place two years earlier, when a formula for profit-related pay was introduced. The result of negotiations was a higher bonus, but one exclusively linked to the German car-manufacturing sites.

Overall, the interviews revealed no convincing evidence that MNCs

relate their remuneration decisions for German sites to the pay principles of firms abroad. No example was found where HRM payment techniques in subsidiaries outside Germany were subsequently disseminated to other parts of the company, as Ferner and Varul suggest (1999: 29). This does not necessarily contradict the results of Ferner and Varul. The evidence relies on interviews with managers in the home country who might underplay the degree of external influence or might not even be aware of it. This sounds plausible especially in the case of informal mechanisms for transferring payment systems, such as the cross-national flows of personnel and international networks discussed by Ferner and Varul (2000: 130–2). Still, no evidence was found of proactive attempts by German companies to ‘copy’ payment systems from their foreign subsidiaries.

However, the degree of internationalization of a firm and its tendency to use incentive-based remuneration systems correlate highly ( $r = .631^{**}$ ,  $N = 54$ ; see Figure 1). The degree of internationalization is measured by three variables: foreign sales as a percentage of total sales, foreign employees as a percentage of total employees, and the geographical spread of a firm’s activities abroad. The 17 companies that are subsidiaries of foreign MNCs were excluded; while they usually have only little international activity, they may be subject to strong international influences from their parent company (see Hassel et al., 2000).

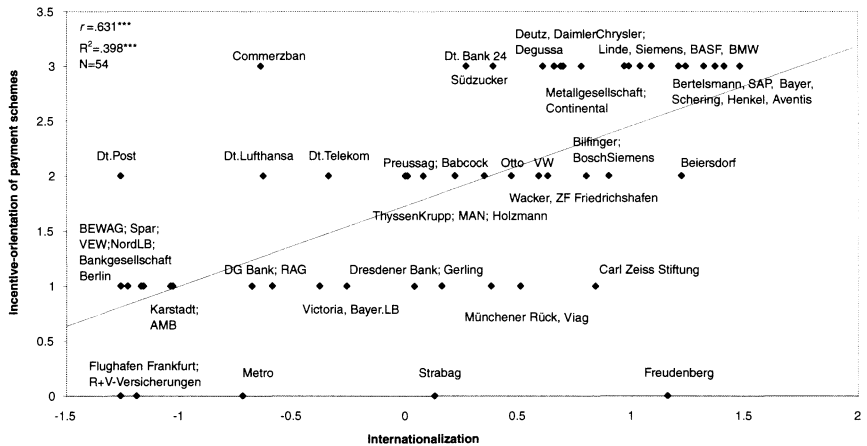
To provide a measure of the degree to which remuneration systems were performance related, the three forms of income that potentially vary with individual or company performance were examined. One point was given to a company for the existence of performance-related pay, one for profit-related pay and one for financial participation. The points were added up, forming a scale from zero to three. This index could be constructed for all 90 companies.

Looking closer at the correlation matrix of the remuneration index and all single variables of the internationalization index, it becomes obvious that it is foreign sales as a percentage of total sales that pushes this statistical correlation, followed by the percentage of foreign employees and the geographical spread (see Table 3).

A regression analysis also reveals that foreign sales are the driving factor in the use of flexible remuneration schemes. The adjusted  $R^2$  equals  $.322^{***}$  ( $N = 67$ ) as compared to  $.153^{**}$  ( $N = 68$ ) for the percentage of foreign employees, although the percentage of foreign sales and of foreign employees correlate highly and both variables have explanatory power. A high percentage of foreign sales shows that the company depends to a large extent on selling goods internationally in highly competitive product markets. Hence, cost-cutting pressures are extremely high, whereas a high proportion of foreign production activities might represent a cost-cutting measure in itself.

To sum up, there is clear evidence of a significant impact of the degree

FIGURE 1. Internationalization of companies and incentive-orientation of their payment schemes for non-executive employees, late 1990s



Source: Databank of the 100 largest German companies, MPIfG

of internationalization of companies on remuneration practices in Germany. This influence does not seem to be primarily based on production sites abroad, however, as was also confirmed in interviews. The high impact of foreign sales as a percentage of total sales (which remains when controlling for size and sector) indicates rather that variable pay is regarded as a tool for remaining competitive in global markets. Thus the increase in variable wage components is a consequence of internationalization because increasing competition puts pressure on labour expenditure. An international business environment requires flexibility and as Heywood et al. (1998: 243) state, 'intense market competition encourages variable pay as a means to control labor costs'.

### Shareholder Value Orientation

A further correlation exists between the flexibility of compensation schemes for non-managerial employees and the shareholder value orientation of large German companies (see Figure 2) ( $r = .560^{**}$ ,  $N = 30$ ).<sup>4</sup> The shareholder value index consists of four variables: the incentive orientation of managers' pay, the existence of targets for annual rates of return, the quality of information given in companies' annual reports, and the quality of their investor-relations work (see Höpner, 2001). Performance-related pay for managers is one of the key characteristics of a shareholder value-oriented strategy. What is noteworthy, however, is the 'trickle-down effect' of the introduction of performance-related pay for managers

**TABLE 3. Correlation Matrix: Indicators for Internationalization and the Incentive Orientation of Payment Schemes**

	Incentive orientation			
	Pearson's <i>r</i>	R <sup>2</sup>	Adjusted R <sup>2</sup>	N
Internationalization index	.631**	.398***	.386***	54
Foreign sales as a percentage of total sales	.576**	.332***	.322***	67
Foreign employees as a percentage of total employees	.407**	.166**	.153**	68
Geographical spread	.481**	.232***	.219***	61
Shareholder value index	.560**	.314**	.290**	30

\*\* = significant at the 0.01 level.

\*\*\* = significant at the 0.001 level.

to other groups of employees, a phenomenon for which there are several explanations, as follows:

- 1 A shareholder value strategy by definition often includes performance-related pay for all employees, not only for managers. Company performance is supposed to be the prime focus for every employee, and with financial participation both shareholder and employee benefit from the congruence of targets. One works council member also mentioned that a company has to present performance-related pay as an important management tool in the annual report in order to attract shareholders.
- 2 As bonuses for managers and dividends for shareholders rise, employees demand their slice of the cake as well. Bonuses can be used to reduce the conflict between shareholders and employees. A similar argument applies to the conflict between managers and employees. For managers, it is easier to justify their own high income if high bonuses are paid to the whole workforce.
- 3 Shareholder value strategies once implemented simplify the introduction of profit-related pay because the relevant business indicators must be calculated and announced in any case. When target rates of return are set, a reasonable reward when targets are met sounds plausible.
- 4 Companies introduce shareholder value strategies partly as a protection against hostile takeovers. The increase in employee ownership can also function as such a protection and might therefore gain prominence in the future should hostile takeovers become more common in Germany (Höpner and Jackson, 2001).

Companies with a high shareholder value orientation also offer higher financial participation compared to other companies, and their



profit-related pay is more often based on a fixed formula compared to companies where it is negotiated between the works council and management.

Regression analysis identifies the degree of shareholder value orientation (adjusted  $R^2 = .29^{**}$ ,  $N = 30$ ) and the percentage of foreign sales within total sales (see above) as the major factors explaining the adoption of variable pay, even after controlling for size and sector. When put into one regression, both factors maintain their significant impact and explain 62 percent of the variance in flexible pay ( $N = 28$ ). The empirical evidence supports the assumption that variable pay is predominantly used by companies that compete in global markets and have adopted a shareholder value orientation. The rise of variable pay in Germany can thus be explained by rising competition in world markets and the growing influence of capital markets.

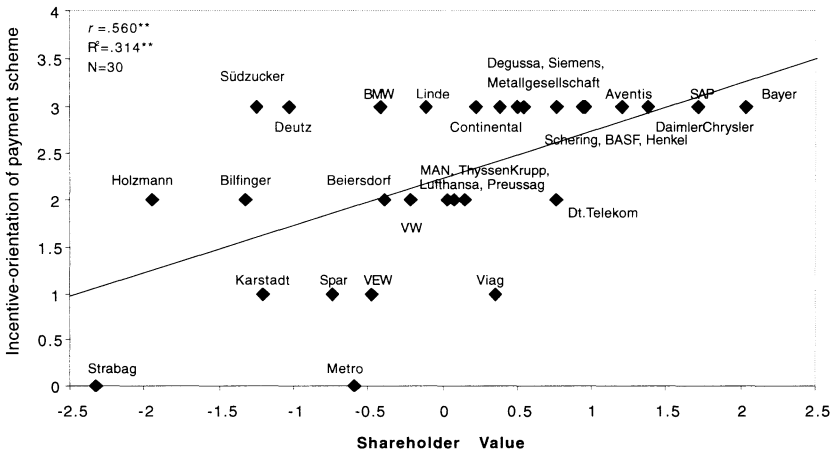
All that remains is to explore the biggest supposed obstacle to variable pay: the German system of industrial relations.

## The German System of Industrial Relations: Incorporating Variable Pay

### Contingent Pay and Collective Bargaining

Given the huge and increasing variety of variable pay programmes that conform to collective agreements, collective bargaining does not seem to

FIGURE 2. Shareholder value orientation of companies and incentive-orientation of their payment schemes for non-executive employees, late 1990s



Source: Data bank of the 100 largest German companies, MPIfG

be an obstacle to the implementation of variable pay. There is clearly still leeway for many companies to pay performance-related rewards above collectively agreed basic pay. Some 65 percent of companies that distribute such rewards pay them in addition to rates established in industry-level agreements.

A real obstacle to the introduction of new forms of variable pay seems to be collective agreements that contain strict rules on performance-related pay, as has been the case in the engineering sector since the 1970s. They include rules on how to measure performance, how to distribute bonuses and even on the budget available for such payments. In practice, remuneration under most of these systems does not really vary according to individual performance, but serves as additional, relatively stable income that increases with tenure. However, quite a few collective agreements incorporating new forms of contingent compensation have emerged recently, although exclusively at firm level. Hence contingent pay does not only emerge 'in spite of' collective agreements, but in some cases is also supported by collective bargaining.

A new and highly publicized form of a collective agreement was that at Debis (Daimler Chrysler Services AG) in 1999. It stipulates that up to 10 percent of annual income depends on individual performance and a further 10 percent on the performance of the company. This agreement was reached by the metal industry union (IG-Metall) and Debis. It is open for other companies in the IT sector to use the agreement, but no other firm has so far applied it; however, other companies such as Infineon are trying to implement similar agreements. Other company-level agreements link part of the negotiated wage increases to the economic performance of the firm: it is agreed in advance that if a certain performance is reached, additional wage increases will be awarded and consolidated into basic pay (see, for example, the collective agreement at Schott AG). Some companies determine the volume of profit-related pay retrospectively (that is, in relation to the last financial year) during collective wage negotiations, potentially replacing part of the wage increases claimed by the unions (see the case of Lufthansa AG). Since annual bonuses have no effect on subsequent wage increases, works councils and unions do not like a mixture of regular wage increases and annual bonuses, but prefer higher increases in wage rates.

While linking wage increases or formerly fixed payments at least partially to the economic performance of the individual firm is seriously discussed by the metal industry employers' association, it is just as seriously rejected by IG-Metall. Incorporating such variable components into collective agreements would put an end to industry-wide collectively agreed wages or at least lower the portion of income that is collectively agreed to. Thus, one of the main functions of collective bargaining (to attain a homogeneous wage structure) would no longer be fulfilled.

As for individual performance-related pay, there also seems to be a tendency to replace formerly fixed payments or potential wage increases by a budget for performance-related bonuses. In the 2000 bargaining round, Deutsche Telekom agreed a model that increases wages by 1 percent and uses a further 2.15 percent for variable components. For the forthcoming year, an aggregate increase of 2.3 percent was agreed, to be distributed to employees according to individual performance. The employers' association of the banking industry recently attempted to convert the fixed payment of an extra month's salary into a budget for performance-related pay. Although the unions agreed to discuss it and were committed to coming up with a suggestion by the end of 2000, nothing has happened so far.

IBM has implemented a company agreement that separates individual wage increases from collectively negotiated increases. A bargaining round is provided for, but this does not lead to a linear wage increase for every employee. This is possible because IBM pays wages 'above the going rate'. Following bargaining between the company and the union, the works council and the employer will negotiate a wage matrix, linking wage increases to performance levels. In cases of poor performance, the collectively negotiated wage increase is consolidated into basic pay, but the portion of the employee's former income in excess of the collectively set 'going rate' is correspondingly reduced. Thus actual wage increases can only be achieved by good performance and are not awarded automatically.

Collective agreements on variable pay support the differentiation of wages over time as well as between firms and individual employees. Bargaining no longer provides steady and linear wage increases, but leads to an increase in the volume of wages, depending on the performance of the company, which is distributed unevenly among individuals. This development can only be observed at company level, however. As yet, collective agreements at industry level do not include variable wage components that could possibly lead to income losses. But while traditional variable pay systems, such as piece rates, were subject to collective bargaining, the new forms of variable pay are rather 'an individualist management tool and may be used to either replace collective bargaining or reduce its significance in pay determination' (Gunnigle et al., 1997: 126). Thus, the role of trade unions in wage formation might become marginalized.

### **Contingent Pay and Codetermination**

Works council participation rights set potentially tighter constraints on variable pay systems than collective bargaining, as the examples of foreign companies in Germany have shown. On the other hand, these cases reflect the fact that works councils insist on their right to negotiate, rather than

the rejection of variable pay in general (see also Muller, 1999). While there is no single pattern of works council attitudes to variable pay, some tendencies emerge. As long as they can achieve transparency of procedures and possibly a rise in income, works councils tend to be open to variable pay even if it leads to growing wage dispersion and higher income uncertainty. However, if variable components replace formerly fixed payments, works councils tend to reject variable systems, or to dilute them, for example, by lowering the spread between the minimum and the maximum bonus or by expanding the number of employees entitled to a financial reward (for example, by lowering the requested level of performance). Such dilution frequently leads to roughly the same increase for most employees, so that performance-related wage differentiation turns out to be more modest than management intended.

More than wage dispersion, works councils seem to dislike the fact that the main focus of many performance-based compensation schemes is company profitability rather than individual performance. At first glance it appears that such schemes start from the individual employee and his or her capabilities, and that employees stand to benefit from the closer attention being paid to their abilities. However, concepts such as 'management by objectives' or specific budgets for bonuses adopt a top-down rather than a bottom-up perspective. A company target is set and then broken down to the different levels until every employee knows what he or she is expected to accomplish. The budget for bonuses is set in advance and employees compete for limited bonuses.

Unlike unions, which often object to target setting on the basis that it leads to continually rising standards, works councils did not perceive this as a great threat. They were confident that they could keep standards at an attainable level.

As with individual performance-related pay, works councils do not reject company-wide profit-related pay either, as long as it does not replace currently fixed wage components. Workers do not want to take risks for company results that depend on managers' performance, markets and other factors they cannot influence. However, they are willing to share in a future risk if they can obtain a reward as well. Since the connection between individual and company performance is loose, works councils prefer as the criteria for bonuses business indicators that relate to the performance of the whole company rather than of smaller units. If smaller units are chosen as the point of reference, targets must be adjusted so that the same bonus can be attained in less successful operations where profits are lower because of market conditions — solidarity prevails.

Restructuring the pay system does not necessarily mean a reduction in current costs. Usually, management aims at controlling or reducing personnel costs in the long run. This can be attained by increasing productivity or by reducing future pay increases. Nevertheless, there are cases

where a new payment scheme leads directly to income losses for some employees. Even such systems may be negotiated with works councils to the extent that they have become co-managers acting in the interest of the profitability of the company (Müller-Jentsch, 1995). This is also an indication of the increase in the power of employers in bargaining processes.

To sum up, works councils do not oppose variable pay in general. They are willing to make concessions and they are aware of the opportunities they have to shape variable compensation schemes. Furthermore, works councils frequently use agreement on flexible remuneration to obtain concessions from management on other matters. The works council of Deutsche Bank 24 (the former personal banking arm of Deutsche Bank) agreed to introduce performance-related pay if the bank maintained its commitment to the sectoral collective agreement. Earlier, the bank had threatened to withdraw from the agreement following the spin-off. Whether this is a concession by management is debatable as the employees' gain is merely adherence to the status quo. It demonstrates the shift in the balance of power toward the employer, a development even more apparent for employment pacts (Rehder, 2001; Stumpf-Fekete, 2001). The results are pay schemes that are indeed variable between employees and over time as well as adjustable to the economic situation of the company. At the same time, wage dispersion is kept relatively low, although not negligible, and basic pay is still guaranteed by collective agreements. In some cases, works councils even gain negotiation rights that are not guaranteed under the Works Constitution Act, for example, where they win a say in determining the budget for performance-related pay. The absence of collective regulations on payment systems, together with co-managing works councils that prioritize local over collective interests, brings about a huge variety of company-specific compensation schemes, as described above.

Given this decentralization, the company level gains in importance for wage setting compared to industry or sector. This does not necessarily mean that works councils gain in importance in determining the pay of individuals. The individual wage increasingly depends on market mechanisms and on negotiations between jobholder and supervisor. Market principles, competition and risk sharing become more important, even at the individual level. Works councils are prepared to accept these influences in principle as long as they can restrict and control them by setting rules and guidelines, and as long as the impact of such pressures is transparent.

## Conclusions

The use of variable pay is widespread among large German companies and has become more important recently. The details of variable pay

programmes differ considerably across companies, but all of them place an appreciable share of the pay of employees at risk.

One of the main objectives is to enhance productivity while keeping personnel costs under control. This can be interpreted as an attempt to stay competitive in global markets, as the proportion of foreign sales and the strength of a shareholder value orientation are the main explanatory factors for variable pay. Thus MNCs play a vanguard role in the diffusion of variable pay.

The German system of industrial relations does not prevent the implementation of variable pay in general, but influences the form adopted. Muller (1999: 42) also states that:

it is remarkable that it has been possible for management to introduce HRM techniques such as goal-based appraisal . . . and performance-related pay that are not necessarily welcomed by unions and works councils. This development suggests that there is room for the introduction of HRM elements that are not clearly supported by the German system.

Since Muller collected his data in 1994, many more companies have introduced variable pay (see Table 2). Collective bargaining agreements seem to be flexible enough for companies to shape their own remuneration schemes. At company level, an increasing number of collective agreements actively support increased pay flexibility. Works councils often cooperate, as long as collective agreements are retained and management does not try to implement new systems unilaterally.

Until now company-specific pay systems have coexisted alongside collective bargaining on pay. As yet, variable wage components have not substituted for basic pay. Nevertheless, the emergence of company-specific remuneration systems is reinforcing the decentralization of wage bargaining and the variation in employment relations. This might have major implications for trade unions and workplace representation.

The example of variable pay shows that firms strive to enforce their individual strategic responses to new competitive conditions. They look for decentralization and 'flexibilization' of employment relations. But the move toward decentralization does not exclude unions and works councils. As Katz and Darbishire (2000: 224) argue, 'framework agreements remain intact and constrain the choice of employment patterns at the firm level'. The variation is more controlled than in the UK or the USA and increasing flexibility has been negotiated within the institutions of the German system. In particular, works councils are more involved than before in bargaining at plant level. Works councils act as co-managers, dealing with the special requirements of the single firm. Their principal task is no longer to enforce compliance with collective agreements. As a result, employment relations at enterprise level are becoming

more differentiated, depending also on differences in the balance of power or management style (MPIfG, 2002).

The second pillar of the German system of industrial relations, the system of collective bargaining, supports this process. While remaining formally stable, it allows for more room for manoeuvre for employer and works council within the enterprise. Unions accept more (controlled) flexibility and variation in wages to keep industry-wide bargaining alive. The new flexibility within collective agreements contributes to the stabilization of the formal institution since the alternative would be for firms to exit from the system, in the Anglo-American style (Hassel and Rehder, 2001). Whether this leads to the marginalization of the unions remains to be seen. They are still involved in the development of new remuneration practices. The situation resembles the development of decentralization in other aspects of employment relations; for example, unions are in some cases playing a major role in negotiating employment pacts at company level (Rehder, 2001: 30).

The trend toward flexibility and decentralization and the associated marketization and individualization of employment relations clearly leads in the direction of an Anglo-American business system. However, the change is taking place in a way that harnesses key features of the institutional framework of German industrial relations and clearly shows the embeddedness of German MNCs in the German business system.

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## NOTES

- 1 The term 'performance-related pay' will be used for payments contingent on the performance of individuals, whereas 'profit-related pay' refers to payments related to the performance of the company.
- 2 As part of the research project (see Acknowledgement) company-based data on different aspects of internationalization and industrial relations were gathered by the research team.
- 3 In 1990, in 34 of the Fortune 100 largest US industrial corporations more than 4 percent of company stock was held by employees, with the average being 12.2 percent among these 34 companies (Blasi and Kruse, 1991: 14–15).

- 4 The shareholder value index exists for 40 companies; the remuneration index for 90. The two groups overlap in 30 cases.

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