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An empirical analysis of the 2000 corporate tax reform in Germany: Effects on ownership and control in listed companies

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ABSTRACT

This paper is a first attempt to analyse the implications of the 2000 corporate tax reform on ownership concentration in Germany. The empirical results document a fall in ownership concentration and a decrease in the power of top institutional owners including the big banks. Hence, the description of German corporate governance as a bank-based system may no longer apply. However, even though the corporate tax reform had a significant effect on ownership concentration and on the power of the top-institutional blockholders, the change in the corporate income tax law did not revolutionise German corporate governance. Ownership concentration in 2005 is still high compared to the Anglo-American economies and an active market for corporate control is not observed.

1. Introduction

One of the most significant developments in German corporate governance was the change in corporate income tax law (Körperschaftssteuergesetz), which was introduced in 2000 and took effect at the beginning of 2002. The 2000 corporate tax reform totally abolished the tax on profits from the sale of long-term equity stakes held by banks and large firms in other firms.[1] It was expected that the corporate tax reform would encourage firms to sell off their big share blocks on a large scale and hence create a less concentrated ownership structure in Germany (Lane, 2004). It was also hoped that the more dispersed ownership as a result of the reform would provide investment opportunities for outsiders, make firms more vulnerable to takeovers and thereby create a more active market for shareholder orientation (Deeg, 2001, 2005a, 2005b).

The change in the corporate income tax law was presumably introduced because many politicians and economists were critical of the strong control of banks and disabled company control by the capital market in Germany and hence thought that it was useful to create a system with more dispersed ownership and a stronger focus on shareholder wealth maximisation (Höpner, 2003). In addition, it was argued that European integration and globalisation, which expand product, labour and capital markets beyond national boundaries expose countries to the pressure of adopting a governance system that comes as close as possible to the outsider controlled model of the Anglo-American economies (Walter, 1993). However, the Anglo-American system with its dispersed ownership structure is an exception as typically most economies have very concentrated ownership (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1999). One explanation that has been put forward to explain this high level of ownership concentration is that it may be the result of weak shareholder protection (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1997; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998). It is hence not clear whether one can expect major changes to ownership concentration in Germany just as a consequence of the corporate tax reform.

By assembling a new and unused dataset, the aim of this paper is to investigate how ownership concentration has changed in Germany as a response to the 2000 corporate tax reform and to thereby assess the extent to which significant changes have taken place in the German system of corporate governance. To the best of our knowledge, it is the first attempt to analyse the effects of the 2000 corporate tax reform on ownership concentration in detail. A dataset describing ownership of German listed companies for the years 1999, 2001, 2003 and 2005 is used. The data is based on the disclosure standard under the 1995 transposition of the European Union's Large Holdings Directive into German law under which companies are required to disclose voting blocks larger than 5%. The empirical findings document a significant decrease in ownership concentration from 2001 to 2005. It is also found that the power of top institutional owners including the big banks decreases significantly. The description of the German corporate governance system as a bank-based system may hence no longer apply.

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[1] The exemption from corporation tax of capital gains from the sales of shareholdings between corporations that have been held for more than a year formed part of the 2000 German Tax Reform. For a detailed investigation of the contents of this tax reform, see Keen (2002).

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However, because ownership concentration overall is still very high among listed companies in 2005 and no active takeover market is observed, the findings of this paper suggest that the 2000 corporate tax reform did not revolutionise corporate governance in Germany. Hence, the findings of this paper give support to Hackethal, Schmidt, & Tyrell (2005), who interpret the changes in the German corporate governance system as representing a modernization of the old system as opposed to a convergence towards a capital market-based system.

The remainder of this paper is organised as follows: Section 2 provides an overview of the empirical evidence and theories of corporate ownership. Section 3 outlines the method and data used in this paper. Section 4 presents the results. Section 5 concludes.

2. Ownership concentration: theory and evidence

Ownership concentration is a central issue of the theory of corporate governance (Shleifer & Vishny, 1997). In the 1990s empirical data revealed that concentrated ownership dominates worldwide with the exception of the US and the UK (La Porta et al., 1999). There is very little empirical evidence on whether this concentrated ownership that was observed in the 1990s has been stable or whether there have been important changes in ownership structures. Van der Elst (2000) and Wojcik (2003) both observe falling ownership concentration and a growing number of widely held firms in Germany in the late 1990s. Wojcik (2003) concludes that whilst ownership concentration in Germany seems to have fallen in the late 1990s it is still very high in comparison to other countries.

Several explanations have been put forward to explain this very high level of ownership concentration in Germany. It has been argued that the high ownership concentration observed in the traditional system of German corporate governance is necessary for a system with codetermination, because, given the powers of employees; owners could not assure themselves a return on their investment without large shareholdings (Roe, 1998). However, as Hassel (1999) argues there is evidence that labour and works councils have greatly lost influence in recent years and are now less of a challenge to investors. In addition, Höpner (2003) shows that codetermination has proved to be compatible with the adoption of the practice of shareholder value at least until the early 2000s.

Given this evidence, an alternative explanation of the very high ownership concentration in Germany is needed. According to La Porta et al. (1998), the highly concentrated ownership structure in Germany may be the result of weak shareholder protection. La Porta et al. (1997, 1998) argue that the widely held corporation is likely to be more common in countries with good legal protection of minority shareholders because in these countries controlling shareholders are less likely to be expropriated if they lose control through a takeover.[2] Hence, controlling shareholders may be willing to cut their ownership of voting rights in order to raise funds or to diversify. According to this theory, the developments that took place from the mid-1990s until the beginning of the millennium, which strengthened the position of minority shareholders, might have contributed to a more disperse ownership in Germany. Among those developments were the creation of a new supervisory authority, the Bundesaufsichtsamt fur den Wertpapierhandel (BAWe, since 2002 incorporated into the new Bundesanstalt für Finanzaufsicht, BAFin) (Hackethal et al., 2005). Furthermore in 2002 the new German takeover law was introduced, which incorporated a mandatory takeover bid (Schmidt, 2004). Some authors argue that these developments greatly improved investor protection in Germany and that the assessment of La Porta et al. (1998), which views German capital markets as underdeveloped does not seem justified any more (Nowak, 2004; Theissen, 2004). However, others stress that the new supervisory authority lacks enforcement power and that it is hence difficult to argue that the new legal elements pave the way for an active market for shareholder orientation (Bhattacharya & Daouk, 2004).[3] It is hence not clear whether one should expect ownership concentration to have fallen as a result of these developments.

Research on the German corporate governance system has not only found a very high level of ownership concentration but has also emphasised that a majority of owners of listed companies are financial and non-financial firms (Franks & Mayer, 2001). La Porta et al. (1998) claim that Germany is in fact one of the few countries in which financial institutions play an essential role as owners. However, some research also shows that the description of the German system as bank-based is not confirmed by the empirical evidence (Edwards & Nibler, 2000). It has been argued that the role of banks in holding equity stakes has been overemphasised. Banks may frequently hold equity stakes as the result of rescuing firms that are in financial distress. Banks may have no desire to hold large equity stakes for control purposes but may simply find that they end up with them as a result of cancelling the debts of financially distressed firms and replacing them with equity stakes. According to this view, it can be expected that the corporate tax reform induced banks to reduce these equity stakes because they no longer faced a large tax bill when selling them.

Non-financial firms also have an essential role as owners and there exist plausible theoretical arguments for why non-financial firms hold equity stakes for control purposes. As Goergen et al. (2004) point out for a non-financial firm such as a car manufacturer a large shareholding in a supply firm can yield an important strategic advantage. By being represented on the supervisory board of the supplier, the car manufacturer can obtain private information on the firm's cost structure or on supply contracts with competitors. The presence on the supervisory board can also mitigate hold-up problems. Since the supplier can put the car manufacturer into a difficult position by not delivering the necessary car supplies on time, the manufacturer has a strong incentive to buy equity in the supply firm and hence to ensure the delivery. If the above arguments are correct, then it is likely that the 2000 corporate tax reform would have a less significant effect on ownership of non-financial firms as many of these firms enjoy benefits of control from holding large voting blocks.

It is hence not only important to assess whether ownership concentration has been stable, it is also essential to investigate whether the structure of owners of listed companies has changed and whether top institutional owners such as big banks maintained their power in corporate governance. There are several studies on the structure of share ownership in Germany before the corporate tax reform was implemented. Prigge (1998), covering the period from 1984 to 1996, finds that the share of non-financial corporations is growing whilst that of financial corporations is stable. Wojcik (2003), investigating data for the years 1997 and 2001, finds that the share of non-financial corporations is increasing whilst that of the financial corporations is falling. There is very little research on whether the role of top institutional owners has been changing. However, the observations of O'Sullivan (2000) and Guillén and O'Sullivan (2004) suggest that big banks and insurers are selling their stakes and leaving boardrooms.

[2] This seems to be confirmed by evidence from the UK for example, where there exists a combination of very dispersed ownership and strong minority shareholder protection.

[3] For an exhaustive list of developments, see Höpner (2001).