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**Origins of German Corporate Governance and Accounting 1870-1914:
Making Capitalism Respectable**

Jeffrey Fear, Harvard University

Christopher Kobrak, ESCP-EAP, European School of Management

Abstract: After comparing the great divergence in post-World War I financial reporting in Germany and the U.S. (*Business History Review* Spring 2006), the authors examine the conceptual foundations, institutional embeddedness, and principles of German and American corporate governance and public financial reporting before World War I. Although America had weaker accounting regulation before World War I than Germany, for the most part, investors felt fairly familiar with corporate governance practices in the two countries. German investors in the U.S. would have felt both familiar, but extremely upset by corporate governance in America. Both countries were bank-based: firms had bank representatives on boards in roughly equal levels; intermediaries and relationships supplemented formal accounting information. Both countries had vibrant equity markets. However, much of the existing literature neglects how history and culture influenced the manner in which accounting subsequently developed in each country's corporate governance system. It also ignores the extent to which a transnational dialogue about best practices crossed the Atlantic, whereby Germany was initially held as a model for corporate governance regulation: for instance, investor protection and required publication of financial accounting, as well as central bank regulation.

This began to change around 1900, especially with the development of accounting in U.S. "public service" industries and the "Great Merger Movement" that began to separate ownership from control. Public pressure and resulting regulation helped enhance capital markets in the U.S. in ways that increasingly encouraged a system of financial reporting and accountancy designed for outsiders rather than insiders. By contrast, German experiences with capital market instability reinforced already-existing suspicious attitudes against capitalism and equity ownership, leading to calls for a system in which stability, reputation, and respectability became paramount virtues—classic 19th century *bürgerlich* (bourgeois) values. Family or personal ownership control was encouraged, and large banks became "trustees" or "stewards" for investors as well as pillars of stakeholder and social cohesion. Accounting norms encouraged stability of the ongoing enterprise itself.

The paper explores the intersection of such deep-seated attitudes and values (culture) in the formation of German corporate governance and public reporting measures. The paper suggests that these entrenched, long-standing views about the purpose of corporations and capital markets in each country will, at the very least, significantly slow down the convergence process, a major topic of current discussions about corporate governance.

“The most hated sort (“wealth getting”, my note), and with the greatest reason, is usury, which makes a gain out of money itself, and not from the natural object of it. For money was intended to be used in exchange, but not to increase at interest. And this term interest, which means the birth of money from money, is applied to the breeding of money because the offspring resembles the parent. Wherefore of all modes of getting wealth this is the most unnatural.”

Aristotle, “Politica,” trans. by Benjamin Jowett, *The Basic Works of Aristotle*, ed. Richard McKeon, 1141.

“The stock market is an academy for circumventing the law.”

Eduard Lasker, Leader of the Liberal Party in Germany, 1873, quoted in Johann Christian Meier, *Die Entstehung des Börsengesetzes vom 22. Juni 1896*, 33.

“It is a financial affair,” replied Veitel. “A financial affair,” repeated the drunken man. “And there you are great, great as a person, great as swindler. Whoever wants money from you is lost.”

Gustav Freytag, *Soll und Haben*, 561.

I. Introduction.

Over the past fifteen years, a voluminous wave of corporate governance studies about the proper control of corporations have become an important part of contemporary academic and business discussions. Corporate governance has become such a large issue because it fundamentally helps determine “the direction and performance of corporations.” Such regulations implicitly answer the fundamental questions about business: Who does a corporation work for? What is its role in society? How should it present its performance to investors. Not surprisingly, increasing cross-border capital investment has placed much pressure on national systems of corporate governance and financial reporting to conform to internationally accepted practices, which often imply convergence to American standards and expectations.¹

¹ Robert Monks and Nell Minow, *Corporate Governance* (Cambridge, Mass.: Blackwells, 1995), p. 1. Fear, Jeffrey R., “Constructing Corporations: The Cultural Conception of the Firm,” *Big Business and the Wealth of Nations*, (eds.) Alfred D. Chandler, Jr. and Takashi Hikino (Cambridge, Mass.: Harvard University Press, 1997), pp. 546-574. For an argument about the necessity of convergence: “The triumph of the shareholder-oriented model of the corporation over its principal competitors is now assured...., see

Much contemporary literature, however, often juxtaposes a fairly static and stylized Continental (usually Germany as a proxy or ideal-type) or Japanese bank-based model against an “Anglo-Saxon” capital market model.² This literature tends to describe the state of corporate governance since the 1980s and tends to neglect historical change within national governance systems as well as to avoid historically accurate comparisons. As we will demonstrate in this article that concentrates on the German case, this literature tends to read backward the German corporate governance system of the 1980s into the period prior to 1914. Without denying institutional antecedents that became decisive *after* World War I when German corporate governance and financial accounting diverged more greatly from American standards, Germans created model corporate governance regulations, particularly in reaction to the financial crisis of 1873, when they learned particular “lessons” about corporations and capital markets.³

What they learned and why is a central part of this article. Both countries wrestled with fundamental issues of building trust in large corporations and capital markets; “speculators” and big business in both countries were viewed suspiciously.⁴ However, regulators slowly began answering this issue of trust and control in different ways. The assumptions behind these regulations and institutions—over time and *only after* World

Henry Hansmann & Reinier Kraakman, “The End of History for Corporate Law,” *Convergence and Persistence in Corporate Governance* (Cambridge: Cambridge University Press, 2004), pp. 33-68.

² Michel Albert, *Capitalism vs. Capitalism* (New York: Four Walls Eight Windows, 1993). Glenn Morgan, Richard Whitley, and Eli Moen, *Changing Capitalisms?: Internationalization, Institutional Change, and Systems of Economic Organization* (Oxford: Oxford University Press, 2005). Peter A. Hall and David Soskice, *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford: Oxford University Press, 2001). Wolfgang Streeck and Kozo Yamamura, *The Origins of Nonliberal Capitalism: Germany and Japan in Comparison* (Ithaca: Cornell University Press, 2001). Ronald Dore, *Stock Market Capitalism: Welfare Capitalism: Japan and Germany versus the Anglo-Saxons* (Oxford: Oxford University Press, 2000). Herbert Kitschelt, Peter Lange, Gary Marks, John D. Stephens, *Continuity and Change in Contemporary Capitalism* (Cambridge: Cambridge University Press, 1999). Thomas K. McCraw, *Creating Modern Capitalism: How Entrepreneurs, Companies, and Countries Triumphed in Three Industrial Revolutions* (Cambridge, Mass.: Harvard University Press, 1997). J. Rogers Hollingsworth and Robert Boyer, *Contemporary Capitalism: The Embeddedness of Institutions* (Cambridge: Cambridge University Press, 1997). Jeffrey A. Hart, *Rival Capitalists: International Competitiveness in the United States, Japan, and Western Europe* (Ithaca: Cornell University Press, 1992).

³ Jeffrey Fear and Christopher Kobrak, “Diverging Paths: Accounting for Corporate Governance in America and Germany,” *Business History Review*, 80 (Spring 2006), pp. 1-48.

⁴ Louis Galambos, *The Public Image of Big Business in America, 1880-1940: A Quantitative Study in Social Change* (Baltimore: Johns Hopkins University Press, 1975). David A. Zimmermann, *Panic: Markets, Crises, and Crowds in American Fiction* (Chapel Hill: University of North Carolina Press, 2006). Jonathan Ira Levy, “Contemplating Delivery: Futures Trading and the problem of Commodity Exchange in the United States 1875-1905,” *American Historical Review*, Vol. 111, No. 2 (April 2006), pp. 307-335.

War I—tended to lock-in a particular form of corporate governance and financial reporting that has influenced German business until the present.

This article attempts to show how history and culture (a web of meanings betraying preferences, values, beliefs, and attitudes) influenced this learning and subsequent institutionalization of particular forms of corporate governance and financial accounting developed in Germany prior to 1914. Contemporary literature ignores the extent to which a transnational dialogue about best practices criss-crossed the Atlantic prior to 1914, whereby Germany was initially held as a model for corporate governance regulation: for instance, in regards investor protection, required publication of financial accounting, and central bank regulation.⁵ Although America had weaker accounting regulation before World War I than Germany, for the most part, contemporaries felt fairly familiar with corporate governance practices in the two countries. Both countries were bank-based: firms had bank representatives on boards in roughly equal levels; intermediaries and relationships supplemented formal accounting information. Both countries had vibrant equity markets, but with some crucial, significant institutional differences (discussed below), particularly associated with banks.

This rough congruence began to change in the decades surrounding 1900, especially in the U.S. with the “Great Merger Movement” that began to separate ownership from control, a series of exposés and investigations about the “money trust” after the 1901 and 1907 panics leading to the Pujo commission of 1912/13, and the development of accounting in “public service” industries such as railroads and utilities. Public pressure and resulting regulation helped (sometimes inadvertently) enhance capital markets in the U.S. in ways that increasingly encouraged a system of financial reporting and accountancy designed for outsiders rather than insiders. In the U.S., populist and progressive reactions tended to cluster around the notion of fairness and transparency for outsiders (such as the “people’s market” of Louis Brandeis, a “free and open” stock

⁵ We have also already forgotten how much Americans glanced toward Germany and Japan prior to the early 1990s for corporate governance lessons. See Michael E. Porter, “Capital Disadvantage: America’s Failing Capital Investment System,” *Harvard Business Review* (Sept.-Oct. 1992), Reprint No. 92508. Paul Warburg was crucial for establishing the Federal Reserve. Debates about establishing the Federal Reserve were heavily informed by German practices in both personal and academic terms, sometimes as a model, other times as a countermodel. A similar argument is advanced by Julian Franks, Colin Mayer, and Hannes F. Wagner, “The Origins of the German Corporation—Finance, Ownership and Control,” October 2005, University of Mannheim, Discussion Paper No. 65, SSRN website, forthcoming in *Review of Finance*.

exchange, “sunshine commission” or “blue-sky laws,” or “fair return” and “fair value” in accounting), building in safeguards to make markets more transparent for investors to save them from potentially rapacious insiders (bankers) abusing “other people’s money.”⁶ In the U.S., interlocking directories of insiders—for years the standard way of doing business in both countries—became increasingly viewed as an insidious “money trust” that had to be combated.

By contrast, German traumatic experiences with capital market instability reinforced already-existing suspicious attitudes against liberal capitalism (*Manchestertum*), joint-stock companies, and speculation, leading to calls for a system in which stability, reputation, and respectability became a paramount virtue—classic *bürgerlich* (bourgeois) values. Family or personal ownership control was encouraged; large banks profiled themselves as “trustees” or “stewards” for investors as well as pillars of social cohesion. The degree of interlocking directories among banks and firms grew more strongly in Germany than in the U.S. after 1900, but especially after 1914. For various reasons, accounting regulations encouraged building reserves to smooth earnings (allegedly stabilizing the volatility of capitalism) and enhancing the solidity (*Substanz*) of the firm. Insider governance by people or institutions with an ownership ‘stake’ in the company was implicitly held to be a virtue, not a vice; distant shareholders (speculators or *Gründer* (founders or promoters)) were viewed as footloose, potential parasites draining healthy businesses of necessary investment capital. (Hearing echoes of today’s fear of “locusts” devouring good, solid German companies is more than warranted.)

The juxtaposition between Germany and the U.S. has played an important part in scholarly discussions, but we will concentrate on the German case with references to U.S.

⁶ Louis D. Brandeis, *Other People’s Money and How the Bankers Use It* (New York: Frederick A. Stokes, 1914). Brandeis took the phrase “other people’s money” from the notorious insider speculator and muckraker, Thomas Lawson, *Frenzied Finance: The Crime of the Amalgamated* (New York: Ridgway, 1905). We are grateful to Janice Traflet for this advice. Traflet’s own work stresses that even after the depression and the Second World War, the New York Stock Exchange had severe legitimation issues, see Janice Traflet, “Own Your Share of American Business:’ Public Relations at the NYSE during the Cold War,” *Business and Economic History On-Line*, Vol. 1 (2003), pp. 1-21, available at www.thebhc.org/publications/BEHonline/2003/Traflet.pdf. *Ibid.*, “Spreading the Ideal of Mass Shareownership: Public Relations and the NYSE,” *Essays in Economic and Business History* (2004), pp. 257-273. *Ibid.*, *Spinning the NYSE: Power and Public Relations at the Big Board* (Dissertation: Columbia University, 2004). Thomas K. McCraw, *Prophets of Regulation* (Cambridge, Mass.: Belknap Press, 1984). Also Julia Ott, *When Wall Street met Main Street: The Quest for an Investors’ Democracy and the Emergence of the American Retail Investor 1900-1930* (Dissertation: Yale University, 2006).

developments by way of contrast.⁷ In many ways, we are following the lead of Mark Roe, who has made an enormous contribution to the study of U.S. corporate governance, by highlighting how a series of political compromises between competing interest groups shaped historical path dependencies. In his book, *Strong Managers, Weak Shareholders* (1994), he argued that many of the distinctive characteristics of the American and other national systems of corporate governance emanated not so much out of national culture or economic necessity, but rather from a series of political compromises between competing interest groups. These compromises, more than any American ideology, produced the salient features of the American system such as dispersed ownership. With Lucian Arye Bebchuk, Roe embellished this idea in a 1999 on the importance of history in determining national corporate governance. They argued that national corporate governance and industrial organization systems differ because of long-standing structural decisions that, in turn, helped determine corporate rules.

As usual, Roe has raised the right issues and offers intelligent answers, but they have not been sufficiently compared to historical reality, especially that outside of the United States.⁸ We will argue that neither economics nor historical path dependencies based on political interest group representation is sufficient for understanding the development of corporate governance systems. Specifically, we will argue that, although both Germany and the United States faced similar economic challenges (as well as the

⁷ Mark Roe, *Strong Managers, Weak Owners* (Princeton: Princeton University Press, 1994); “Political Preconditions of Separating Ownership from Corporate Control,” *Stanford Law Review*, Volume 53, Number 3, December 2000; “Rents and Their Corporate Consequences,” *Stanford Law Review*, Volume 53, Number 6, July 2001; “The Shareholder Wealth Maximization Norm and Industrial Organization,” *University of Pennsylvania Law Review*, Volume 149, Number 6, June 2001; Lucian Arye Bebchuk and Mark Roe. “A Theory of Path Dependence in Corporate Ownership and Governance,” *Stanford Law Review*, Volume 52, Number 1, November 1999. I wish to convey my thanks to Martin Müller of the Deutsche Bank Archiv and Michael Allen of Georgia Tech, and Mark Roe for their assistance.

⁸ In three other recent articles, Roe has taken a rather different tack with little or no reference to his previous work. Using a more theoretical economic style of argumentation, Roe has asserted that Social Democracies are more likely to produce concentrated ownership (2000), that the principle of shareholder wealth maximization will add to social wealth only in countries where industries are not concentrated (2001), and that high corporate rents increase the agency costs of shareholders (2001). Although both Professor Roe’s earlier views and his latest articles add a great deal to our understanding of corporate governance and industrial organization, they need to be examined more thoroughly in light of the historical development of the attitudes toward mechanisms of corporate control, as his first book strongly argued. For instance, although Social Democrats played an immensely important role in the politics of German history, it is not until after 1945 that they permanently gained a seat at the legislative and corporate governance table.

same 1873 “panic”), the political and social reactions to it differed greatly in the two countries because of different underlying collective attitudes toward big business and capital markets. In both countries, a ‘populist’ reaction against big business and speculators arose, but this reaction spoke *a different language*. This difference in language particularly affected the *solutions* rather than the remarkably similar underlying suspicions. In particular, conceptions of bankers and banking differed markedly between Germans and Americans. *Then*, a different set of interest group power relations helped to enact legislation based on these more broadly shared (even if perceived) attributes.

In this respect, we are following Douglass North’s call for integrating the human learning experience, which includes understanding how “mental constructs” (shared beliefs, preferences, perceptions) and derived from contemporary experience and embedded over time in the historical process shaped the process of economic or institutional change. Economies have to evolve “a cultural heritage that led them to innovate institutions of impersonal exchange” that allowed them to succeed.⁹ Both Germany and the United States developed business systems that clearly succeeded over the past 150 years, but they also built in institutional and cultural biases that continue to shape each country’s responses to the first (prior to 1914) and second waves of globalization (after ca. 1971).¹⁰ Historically-determined institutions, corporate rules, and widespread attitudes in both countries continue to affect current ownership structures and impede corporate governance convergence.

In this article, we focus primarily on the roots of *institutionalized* corporate governance rules (many such as the two-tiered board had even longer informal antecedents in practice—see Colleen Dunlavy) and German and American *public* financial reporting. Both of which evolved in reaction to contingent political and social circumstances (i.e. history), as well as being shaped by general attitudes toward share capital, (equity) markets, and perception about the nature and control of corporations (i.e.

⁹ Douglass C. North, *Understanding the Process of Economic Change* (Princeton: Princeton University Press, 2005), quote from p. 18.

¹⁰ Ross Levine and Asli Demirgüç-Kunt (eds.), *Financial Structure and Economic Growth: A Cross-Country Comparison of Banks, Markets, and Development* (Cambridge, Mass.: MIT Press, 2001). Levine has shown that at a historical *macroeconomic* level bank-based systems can contribute to economic growth (GDP) as much as capital markets—or at least they do not necessarily underperform. Both systems channel capital to firms in different manners and thus have different microeconomic and institutional consequences.

culture).¹¹ Moreover, these reactions have often remained surprisingly consistent over time—or at least rhyme—as can be seen by the remarkable parallels to the recent German reaction to the collapse of the Neuer Markt, the disappointing Deutsche Telekom share issues, and the flap about foreign “locusts.”

Finally, we argue that distinctive, deep-seated orientations (attitudes, values, preferences) toward capitalism, corporations, and share capital best undergird this phenomenon. These are not necessarily “national,” as if there were no alternative viewpoints and as if they were not politically contested within the country, but they did represent a dominant, and most importantly, the dominant opinion of interest groups able to enact the legislation. These interest groups reflected broader social constellations of values and utilized these reasons to legitimize their positions.

The paper is divided into two main sections. The first section is broken down into a discussion about German reactions to the “founders’ crisis” (*Gründerkrise*) of 1873; an analysis of early development of German corporate governance (*Aktienrecht*); the special role of banks in the audit function; the introduction of important securities laws (*Börsen- oder Wertpapiergesetz*), especially that of 1896, and finally a synopsis of how those attitudes permeated the structures of German corporate governance. These attitudes underlying legislation permitted banks to play a decisive role in the future of German corporate governance and allowed (family) or concentrated ownership to remain strong. Ironically, Germans essentially institutionalized a version of capitalism envisioned by J. P. Morgan, whereby responsible bankers presided over the economy. J. P. Morgan was a good ‘German’ banker. The U.S. too developed a “Morganized,” bank-mediated economy before 1913, but was subsequently dispersed by legislation and the development of an equity culture *after* the First World War. The second section discusses the growing differences in German and American *public* financial accounting practices that discouraged and encouraged, respectively, the development of an equity culture. In both sections, we highlight how different underlying attitudes and values structured institutional solutions to common sets of problems that made German capitalism differ greatly from the American variety.

¹¹ Fear, “Constructing Big Business.”

II. German Corporate Governance

II.a The Crisis of 1873: Gründerkrise vs. Panics

Gründerkrise!

On February 7, 1873, Eduard Lasker, a short man with little legs whose commitment to liberalism, constitutionalism, and parliamentary democracy acted as a constant thorn in the side of Chancellor Bismarck, stood up at the podium of the Prussian Parliament and gave a three-hour speech that brought down the political house. The Berlin stock market plummeted soon thereafter although in retrospect one cannot blame the speech for bursting the stock market bubble. The ensuing crash and “great depression” was an interdependent, international phenomenon and marked the beginning of a global economic deflation during the first wave of globalization. Although some economic historians have exaggerated the economic effects of the 20-year-long period of slow growth and stagnating prices that followed, the psychological and attitudinal effects of the collapse of the stock market on Germans were enormous.¹²

Lasker accused a number of Bismarck’s closest allies of corruption by accepting bribes for awarding state concessions to build railroads. Lasker railed against them for building railroads along the lines of “System Strousberg,” a lasting term of derision coined by him to describe Bethel Henry Strousberg, the “railway king” and “the man who bought everything.” Strousberg’s incestuous insider political relations and convoluted financial machinations (pyramids of debt, only partially contributing nominal capital, issuing stock under par value—technically illegal at the time). However, the main unspoken assumption between the lines in the speech was that Bismarck was personally

¹² Most economic historians tend to agree with S.B. Saul’s assessment of the period in *The Myth of the Great Depression 1873–1896* (New York: MacMillon Press, 1969). A good comparative or global history of this transnational crisis is still missing. The “panic” began in May on the Viennese Börse and subsequently broadened to Berlin and New York. See E. Ray McCartney, *Crisis of 1873* (Minneapolis: Burgess Publishing Company, 1935), pp. 84-97. Eric J. Hobsbawm, *The Age of Empire 1875-1914* (New York: Vintage Books, 1987), pp. 34-55. Cornelius Torp, *Die Herausforderung der Globalisierung: Wirtschaft und Politik in Deutschland 1860-1914* (Göttingen: Vandenhoeck & Ruprecht, 2005). Peter Gourevitch, *Politics in Hard Times: Comparative Responses to International Economic Crises* (Ithaca: Cornell University Press, 1986). Charles P. Kindleberger, “The Panic of 1873,” *Historical Economics: Art of Science?* (New York: Harvester Wheatsheaf, 1990), pp. 310-323.

involved in lucrative insider dealings. Lasker denied attacking Bismarck, but Bismarck told him: “You shot so closely to me, though, that you would have hit me by a hair.”¹³

Strousberg’s railway empire had already begun to unravel by 1871-72 at the height of the stock market boom, but he played the equivalent and convenient scapegoat role in Germany that Jay Cooke and the collapse of the Northern Pacific Railway did in the U.S. (It did not help that Strousberg was a converted Jew with links to English investors, an English wife, and a shady past.) In September 1873, Northern Pacific’s collapse based on financial overextension forced Cooke into bankruptcy, brought to light numerous financial scandals with the Canadian government, and sparked a scary run on many major banks in Philadelphia and Washington that forced them to temporarily suspend operations.¹⁴

Lasker’s series of “disclosures” (*Enthüllungen*) in the new German Parliament signalled the beginning of the end for that period known as the “founding fever” (*Gründungsfeber*), a bubble in foundings or what we now call “independent public offerings” (IPOs). One contemporary muckraker, Otto Glagau, called Lasker “the fearsome slayer of founders.”¹⁵ The “founders’ crisis” (*Gründerkrise*), an economic hangover after the “founding fever” fueled by unification, loose money, and five million francs of French reparations, was followed by a subsequent recession that contemporaries labeled the “Great Depression.” It speaks volumes that till this day these “founder’s years” (*Gründerjahre* or *Gründerzeit*) refers to the boom and bust of new business firms rather than Germany’s 1871 unification.

To give some sense of scale to this spectacular boom and bust, between 1871 through 1873, 928 new public, joint-stock companies with a nominal share capital of 2.8 billion Marks were founded. In Prussia alone, during the first 21 months of that period, 726 companies were founded in that period compared to a sum total of 276 between 1790 and the middle of 1870. Just after the new free incorporation law of June 11, 1870 was passed, between July 1, 1870 to the end of 1874, in Prussia alone 857 new companies

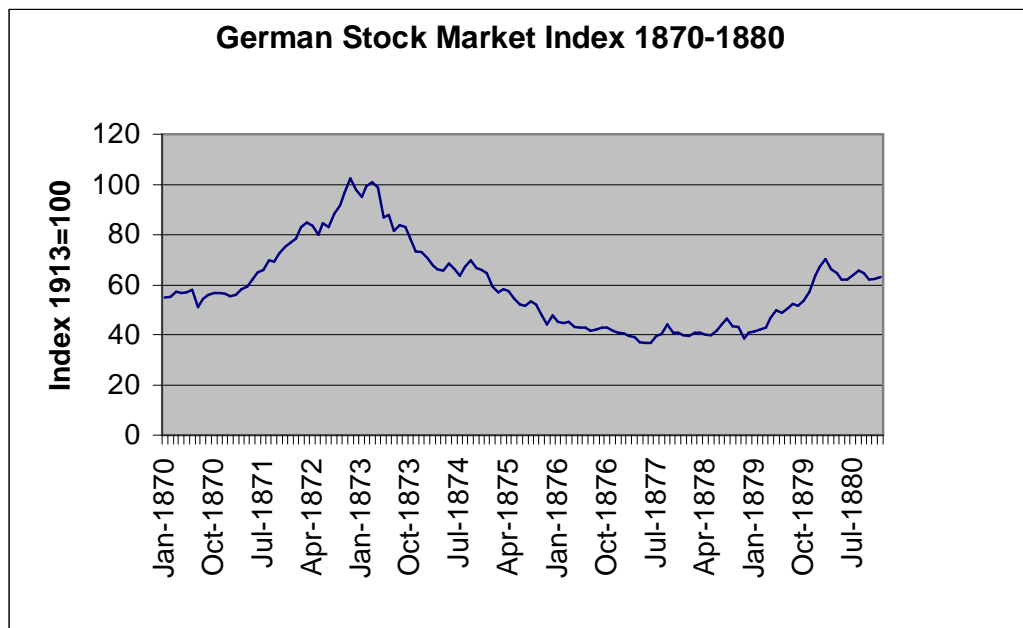
¹³ Quoted in Joachim Borchart, *Der europäische Eisenbahnkönig Bethel Henry Strousberg* (München: C.H. Beck, 1991), p. 173.

¹⁴ A detailed comparison of Cooke’s and Strousberg’s railroad scandals would prove illuminating about the nature of the two capitalisms at the time.

¹⁵ Otto Glagau, *Der Börsen- und Gründungs-Schwindel in Deutschland* (Zweiter Teil) (Leipzig: Paul Froberg, 1877), p. 360.

were founded—over double the total number ever established, worth about 4.3 billion Marks; nearly 80% of those companies were formed during 1871 and 1872 alone. By contrast, for the previous two decades between 1851 and 1870, a total of 336 joint-stock companies worth a total of 2.6 billion Marks were founded. Berlin surpassed Frankfurt as Germany’s foremost financial center, associating itself in the minds of Germans with all the energy of the boom and the malice of the bust. By November 1872, the stock exchange index was 80% higher than in December 1870. In 1872 alone, 479 firms were founded worth almost 1.5 billion Marks (over 50% of total nominal capital of those three years). By contrast, the next strongest year for new IPOs before 1913 was 1899, which saw 364 new joint-stock companies worth a market capitalization of 0.54 billion Marks, just one-third that of 1872.¹⁶

Exhibit 1: German Stock Market Index 1870-1879



¹⁶ Johann Christian Meier, *Die Entstehung des Börsengesetzes vom 22. Juni 1896* (St. Katharinen: Scripta Mercaturae Verlag, 1992), p. 7. Steffen Eube, *Der Aktienmarkt in Deutschland vor dem Ersten Weltkrieg—Eine Indexanalyse* (Frankfurt/Main: Fritz Knapp Verlag, 1998), pp. 28-33. Christoph Buchheim, „Deutsche Finanzmetropole von internationalem Rang (1870-1914),“ *Geschichte des Finanzplatzes Berlin*, (Hg.) Hans Pohl (Frankfurt/Main: Fritz Knapp Verlag, 2002), pp. 104-156.

Source: *Vierteljahrshäfte zur Konjunkturforschung, Sonderheft 36, pp. 98-99.*

After peaking between December 1872 and May 1873, and just after Lasker's dramatic disclosures, on May 9 ("Black Friday") the Vienna exchange dropped by 12%, followed by New York. Panic ensued in both those exchanges. The Berlin stock exchange tended to see a continuous slide rather than panic. It began to decline after April 1873, falling 20% off its peak by October 1873. After the September 1873 failure of Jay Cooke that had international ramifications, it dropped a further 20% by January 1875, thus losing 40% of its peak value within two years.¹⁷ The simultaneous stock market collapses ushered in a world-wide recession, psychologically and significantly referred to as the "Great Depression" by contemporaries. Two years later, by July 1877, the Berlin stock market had lost 60% of its peak 1873 value and did not begin to recover until after January 1879.

The stock exchange crisis immediately became a banking crisis. By October 1873, a wave of Berlin firms announced their bankruptcy. By the end of 1873, about one-third of all Prussian banks failed. Sixty-one banks, four railroads, and 115 industrial companies went bankrupt. By the end of 1875, the average stock had lost 50% of its September 1873 market value. Among 444 Prussian public companies studied by the Prussian Office of Statistics, an estimated more than two billion Marks in market capitalization was lost. Many important individual stocks were made completely worthless. One of the most important mining operations in the Ruhr, the Dortmunder Union, which was backed by Adolf Hansemann of the Disconto-Gesellschaft and Friedrich Grillo, two of the most important bankers in Germany, appeared on the stock market with a price of 110 Talers, doubled to 228, but tanked to just 12.¹⁸ In 1878, the value of startups reached an absolute low for the period before 1913 at just a pitiful 13 million Marks; both 1876 and 1878 saw a low point in the number of startups with just 42 IPOS in each year.¹⁹

¹⁷ Kindleberger, "The Panic of 1873."

¹⁸ Meier, *Entstehung des Börsengesetzes*, p. 10. Günter Ogger, *Die Gründerjahre: Als der Kapitalismus jung und verwegen war* (München: Droemer Knauer, 1982), pp. 177-203.

¹⁹ Eube, *Der Aktienmarkt*, p. 30.

Exhibit 2: German Stock Market Index 1870-1913



Source: *Vierteljahrshefte zur Konjunkturforschung, Sonderheft 36, pp. 98-99.*

For Germany (and the industrializing world), the collapse ushered in a period of significant price deflation and a period of recession in the 1870s. Historians agree that it did not constitute a real depression as growth continued slowly. For instance, production in the iron and steel industry as a whole continued to grow between 1873 and 1879, but this new production chased ever lower prices. However, the price deflation was psychologically shocking to contemporaries, difficult for businesses to master, and created tremendous social tensions. The “social question” dominated German political discourse. Dramatic price falls, especially in agricultural goods, exacerbated by the appearance of American and Russian grain on German markets, led to a virulent campaign for tariffs and price supports from a powerful agrarian lobby. Overall, the wholesale price index plummeted from 118 in 1873 to 79 in 1879 (1913=100), a fall of nearly one-third. Coal prices dropped from M 16/ton in 1874 to M 5.2/ ton by 1879. Between 1873 and 1878, pig iron prices dropped from M 125/ton to just 55 M/ton in

1878; merchant bars from M 242/ton to M 88/ton; and rails from M 378/ton to M 145/ton—roughly 50-60% price falls. The economic historian, Reinhard Spree, estimates that in 1874 and 1875, the average gross profits in the iron and steel industry dropped by 50% in both years. Just under one-half of all blast furnaces in the Ruhr shut down; those still in operation ran at just 50-60% capacity.

The crisis also allowed investment banks to gain significant, but temporary leverage over many industrial firms. The downswing caught even powerful firms like Krupp or Gutehoffnungshütte (GHH), both of which suffered from major liquidity crises. Major industrial associations formed to lobby for protection and government support. One of the few bright spots was the continuing construction of the German railway net, which initially supported demand for iron and rails, but demand dropped even faster than production in the first few years of the crisis.²⁰

Although there are many potential aspects to discuss about this crisis, for our corporate governance purposes Germans vented most of their vengeance on liberal incorporation laws and free trade (so-called *Manchestertum*).²¹ In many respects, the over-stylized, caricatured contrast between “Anglo-Saxon” and German capitalism begins in 1873. The distancing denigration of the “other” variety of capitalism, the reviled *Manchestertum*, was a crucial part of German national identity formation and attitudinal underpinning of much German “national economics,” rather than universal, classical economics rooted in English economists since Adam Smith. The timing of the 1871 unification and 1873 stock market crash brought the two types of “founding” together. Popular opinion thought that such unscrupulous liberal founders ruined the glorious triumph of German military victory and political unification. After U.S. “panics,” writers also questioned the institutional and moral fiber of the nation, but had its (somewhat reinvented) founding myths to fall back upon; the 1873 crash in Germany

²⁰ Wilfried Feldenkirchen, "Banking and Economic Growth: Banks and Industry in Germany in the Nineteenth Century and their Changing Relationship during Industrialisation" in *German Industry and German Industrialisation: Essays in German Economic and Business History in the Nineteenth and Twentieth Centuries* (London: Routledge, 1991), pp. 116-147; also Richard Tilly, "Banking Institutions in Historical and Comparative Perspective: Germany, Great Britain and the United States in the Nineteenth and Early Twentieth Century," *Journal of Institutional and Theoretical Economics* (JITE), 145, (1989), pp. 189-209. Figures and discussion are based on Feldenkirchen, *Eisen- und Stahlindustrie*, pp. 34-51, Tab. 11, 33 and Spree, *Wachstumstrends und Konjunkturzyklen*, pp. 352-363, 372, 464, 470.

²¹ Kindleberger, „Panic of 1873.“ Gourevitch, *Politics in Hard Times*.

appeared to call into question the whole political founding of the Reich. The era of the founders sullied the glorious founding of the Reich.²²

Most of the historiographical literature has focused on the reintroduction of tariffs. The classic, if somewhat outdated, interpretation of German history viewed the advent of tariffs in 1879 and Bismarck's conservative political realignment as an insidious "marriage of iron and rye," the rise of "organized capitalism," and a general "discrediting of liberalism."²³ The so-called "marriage of iron and rye" reestablished moderate tariffs especially on imported grain and steel products. However, according to Sidney Pollard, especially relative to the massive growth in trade before 1914, tariffs "did not have a significant economic impact on the economies in which it was introduced. There was a great deal of political sound and fury associated with it, but it did not signify a great deal, compared with other influences." German tariffs remained "moderately liberal."²⁴ In terms of tariffs, there were few countries that could compare with the

²² On U.S. criticism of stock markets and its relationship to the health of the body politic, see Zimmermann, *Panic*, pp. 39-80. Garry Wills, *Lincoln at Gettysburg: The Words that Remade America* (New York: Simon Schuster, 1992).

²³ Classics of this historiographical vein include Alexander Gerschenkron, *Bread and Democracy in Germany* (Berkeley: University of California Press, 1943 reprinted by Ithaca: Cornell University Press, 1989). Hans Rosenberg, *Grosse Depression und Bismarckzeit: Wirtschaftsablauf, Gesellschaft und Politik in Mitteleuropa* (Berlin: Walter de Gruyter & Co., 1967). Hans-Ulrich Wehler, *The German Empire, 1871-1918* (Oxford: Oxford University Press, 1985). Volker Berghahn, *Imperial Germany* (New Providence: Berg, 1985). Most of the literature focuses on free trade and the reintroduction of tariffs and its party-political implications. For an up-to-date and skeptical discussion about previous literature regarding tariffs, see Cornelius Torp, *Die Herausforderung der Globalisierung: Wirtschaft und Politik in Deutschland 1860-1914* (Göttingen: Vandenhoeck & Ruprecht, 2005). For subtle political arguments about the state of German liberalism, see Margaret Lavinia Anderson, *Practicing Democracy: Elections and Political Culture in Imperial Germany* (Princeton: Princeton University Press). David Blackbourn, *The Long Nineteenth Century: A History of Germany 1780-1918* (Oxford: Oxford University Press, 1998). James J. Sheehan, *German Liberalism in the Nineteenth Century* (Chicago: Chicago University Press, 1978).

²⁴ Sidney Pollard, "Free Trade, Protectionism, and the World Economy," *The Mechanics of Internationalism: Culture, Society, and Politics from the 1840s to the First World War*, (eds.) Martin H. Geyer and Johannes Paulmann (Oxford: Oxford University Press, 2001), pp. 27-53, quote from p. 53. Knut Borchardt, *Globalisierung in historischer Perspektive* (Bayerische Akademie der Wissenschaften, Philosophisch-Historische Klasse, Sitzungsberichte, Jg. 2001, H. 2) (München, 2001), quote from p. 30. Cornelius Torp, "Weltwirtschaft vor dem Weltkrieg: Die Erste Welle Ökonomischer Globalisierung vor 1914," *Historische Zeitschrift*, Bd. 279, 3 (Dezember 2004), pp. 561-609. Niels P. Petersson, "Das Kaiserreich in Prozessen ökonomischer Globalisierung," *Das Kaiserreich transnational: Deutschland in der Welt 1871-1914*, (Hg.) Sebastian Conrad und Jürgen Osterhammel (Göttingen: Vandenhoeck & Ruprecht, 2004), pp. 49-67. Rita Aldenhoff-Hübinger, *Agrarpolitik und Protektionismus: Deutschland und Frankreich im Vergleich 1879-1914* (Göttingen: Vandenhoeck & Ruprecht, 2002). Kevin H. O'Rourke and Jeffrey G. Williamson, *Globalization and History: The Evolution of a Nineteenth-Century Atlantic Economy* (Cambridge, Mass.: MIT Press, 1999), esp. pp. 93-117. Dietmar Petzina, "Isolation und Öffnung: Zwischen National- und Weltwirtschaft," *Geschichte der deutschen Wirtschaft im 20. Jahrhundert*, (Hg.)

“liberal” U.S. that was a highly protectionist regime until after 1945 with average duties in 1913 of 44% on manufactured goods, three times that of Germany. Germany’s tariffs remained modest (13%), more at the European average on par with France, Denmark, or Sweden; only Britain operated with no tariffs.²⁵

Liberal incorporation laws that eased the founding of firms also came in for special vilification. Quite rightly, many foundings often proved no more than fly-by-night schemes to fleece unsuspecting, gullible investors. Unlike the positive connotations of American entrepreneurial startups today, “foundings” and “founders” became dirty words. The crisis sparked debate about whether joint-stock companies were even healthy for the economy. Ultimately, however, corporate governance reforms did not call into question the joint-stock company or liberal free incorporation laws, but tightened supervisory controls over firms, especially new firms, especially regarding the modalities of their founding and issuing of stock. In terms of corporate governance, *continuity* reigned (Section II.b). Much of German corporate governance reform through the 1896 stock exchange laws was designed to ensure that new firms were solid, reputable, respectable entities to avoid the follies of the founding era (Section II.c). Someone had to take responsibility; that role increasingly and sometimes inadvertently fell to banks.

The devastating economic mood of the 1870s permitted the German government to nationalize railroad companies at relatively rock bottom prices as many entrepreneurs simply wanted out. Large banks proved themselves useful in discretely acquiring private railroad shares, for example, without driving up the prices—while protecting Bismarck’s own personal interest in the nationalization of railroads. Both tariffs and railroads played important roles in the fiscal condition of the Reich government, which was almost

Reinhard Spree (München: C.H. Beck, 2001), pp. 90-116, esp. pp. 92-96. Gourevitch, *Politics in Hard Times*, esp. pp. 71-123.

²⁵ The classic literature of German history has made this a central turning point in the political history of Germany. However, in economic terms it is much less a turning point. Tariffs, for instance, remained “moderately liberal” and well within the European average. Forrest H. Capie, *Tariffs and Growth: Some Illustrations from the World Economy 1850-1940* (Manchester: Manchester University Press, 1994), pp. 55. Sidney Pollard, “Free Trade, Protectionism, and the World Economy,” *The Mechanics of Internationalism: Culture, Society, and Politics from the 1840s to the First World War*, (eds.) Martin H. Geyer and Johannes Paulmann (Oxford: Oxford University Press, 2001), pp. 27-53. Paul Bairoch, *Economics and World History: Myths and Paradoxes* (Chicago: University of Chicago Press, 1993), Table 3.3. Aldenhoff-Hübinger, *Agrarpolitik und Protektionismus*.

entirely dependent on the regional states for its revenue.²⁶ By 1890, the nationalization of rail lines had removed companies with a total market value of 2.8 billion marks from exchanges and tripled the kilometer of track owned by the state between 1876 and 1890.²⁷

The nationalization of the railways between 1876-1890 had major inadvertent consequences for German corporate governance and public financial reporting. It pulled the largest, most important, and most profitable sector of industry (over the mid-19th century) off of capital markets. Beforehand, railroads attracted the greatest number of outside and/or foreign investors for both equity and debt. Nationalization also reduced the demand for more sophisticated public financial reporting. In the United States, regulation of railroads and other “public service utilities” such as gas, electrical, and waterworks eventually promoted better financial disclosure requirements for investors and public regulators. Much of the corporate governance and accounting innovations had their origins in the attempt to regulate these privately-owned, “public service” corporations. German accounting increasingly focused more on cost or managerial accounting issues (Section III). Somewhat counterintuitively and unintentionally, American railroad bankruptcies also stimulated many important financial innovations, especially regarding reorganizations and debt-to-equity conversions. Here J. P. Morgan performed immensely important work consolidating and reissuing shares based on the “value” he added and trust he engendered on capital markets.²⁸

²⁶ Aldenhoff-Hübinger, *Agrarpolitik und Protektionismus*.

²⁷ Fritz Stern, *Gold and Iron: Bismarck, Bleichröder, and the Building of the German Empire* (New York: Alfred A. Knopf, 1977), pp. 208-217.

²⁸ Fear and Kobrak, „Diverging Paths.“ Rainer Fremdling, *Eisenbahnen und deutsches Wirtschaftswachstum 1840–1879* (Dortmund, 1985), 132–63; figures from pp. 22–34. See Lothar Gall and Manfred Pohl, *Die Eisenbahn in Deutschland: Von den Anfängen bis zur Gegenwart* (Munich, 1999); Volker Then, *Eisenbahnen und Eisenbahnunternehmer in der Industriellen Revolution: Ein Preussisch/Deutsch-Englischer Vergleich* (Göttingen, 1997). See also Gömmel, “Entstehung und Entwicklung der Effektenbörse,” in *Deutsche Börsengeschichte*, pp. 138–63. Kurt Schmaltz, *Bilanz- und Betriebsanalyse in Amerika* (Stuttgart: XX, 1927, p. 11. Peter Tufano, “Business Failure, Judicial Intervention, and Financial Innovation: Restructuring U.S. Railroads in the Nineteenth Century,” *Business History Review* 71 (Spring 1997): 1–40. Paul J. Miranti Jr., *Accountancy Comes of Age: The Development of an American Profession, 1886–1940* (Chapel Hill, 1990). David F. Hawkins, “The Development of Modern Financial Reporting Practices among American Manufacturing Corporations,” *Business History Review* (Autumn 1963): 135–68. Paul J. Miranti Jr., “The Mind’s Eye of Reform: The ICC’s Bureau of Statistics and Accounts and a Vision of Regulation, 1887–1940,” *Business History Review* 63 (Autumn 1989): 469–509. J. Bradford De Long, “Did J.P. Morgan’s Men Add Value?” in *Inside the Business Enterprise: Historical Perspectives on the Use of Information*, ed. Peter Temin (Chicago, 1991), pp. 205–49.

The causes of one of the greatest speculative booms in German history were straightforward. First and foremost, French war indemnities of five billion French francs helped fuel the speculative boom; many German states became nearly debt free. At the same time, the new Reich adopted the gold standard, but issued new gold Marks before recalling the old silver Prussian Thalers, which nearly tripled the money supply between 1870 and 1873. (The U.S. withdrew silver coinage, which led to its own populist revolts.) As one contemporary journalist (Otto Glagau) argued, the conversion to the Mark as well as the metric system destroyed all sense of healthy, traditional proportion, let alone masked an excuse to raise prices on unsuspecting customers—a similar criticism raised by many consumers against the conversion to the Euro. According to influential Glagau, the currency conversion primarily enriched Jews, liberals, lawyers, and “founders”—all pretty much the same ilk for him. More than any other publicist at the time, Glagau associated crooked stock promoters with Jews. For over two decades after 1873, Glagau created the most influential image of founders, bankers, and stock promoters. The popular portrayal only began to change after 1900.²⁹

Second, the new incorporation law (*Aktiengesetz*), promulgated in June 1870, positively dripped with the *laissez faire* liberal principles of the times. It permitted near unrestricted access to registering firms, especially leading to a boom in new banks eager to lend to a flush of new industrial undertakings. Firms could simply publish their prospectus in the newspapers and list on the exchange inside a week with little to no oversight. Investors could not judge the *Seriosität* of the new venture or the value of its assets. This liberal incorporation law, which had been hurriedly passed inside four days, became the focal point of subsequent corporate governance reform.³⁰ Finally, the euphoria following the victory over France and blood-and-iron unification only heightened collective expectations, personal consumption, irrational exuberance, and get-rich-quick schemes.

²⁹ Glagau, *Der Börsen- und Gründungs-Schwindel*, pp. xxx-xxxv. Morten Reitmayer, *Bankiers im Kaiserreich: Sozialprofil und Habitus der deutschen Hochfinanz* (Göttingen: Vandenhoeck & Ruprecht, 1999), p. 279.

³⁰ Hanno Merkt, *Unternehmenspublizität: Offenlegung von Unternehmensdaten als Korrelat der Marktteilnahme* (Tübingen: Mohr Siebeck, 2001), pp. 59-73. Werner Schubert and Peter Hommelhoff, *Hundert Jahre modernes Aktienrecht* (Berlin: Walter de Gruyter, 1985).

The economic collapse was just as dramatic as it ushered in a profound period of rethinking of classic liberalism in Germany, which easily branched out into anti-capitalist sentiment and anti-Semitic defamation. The great German historian, Fritz Stern, wrote about the psychological impact of the boom of the early 1870s:

For a short dramatic moment – before the inevitable crash – the stock market became Everyman’s Temple of Temptation. The speculative extravaganza completed German’s new perceptions of themselves: it was in this moment of capitalism in caricature that Germans came to realize the degree to which the new economic system had come to dominate their society. They experienced a shock of recognition from which they never fully recovered – and from that time forward, anticapitalism was a strong force in German life.³¹

Although the trigger for the international crisis lay outside Germany and the leader of the free liberal party, Lasker, exposed some of the worst swindles, for his efforts Lasker’s liberal, democratic Progressive Party and its policies suffered the most in the wake of the economic meltdown.

This caricature of capitalism turned into a caricature of capitalism—unbridled, ruthless *Manchestertum*. Exaggerated optimism quickly transformed into exaggerated pessimism and led to the widespread view that: “economic misery was ... attributable to the liberal-capitalist economic system, exposing the political-economic bankruptcy of that system.”³² In the wake of public outcries to systematically investigate the causes of the crash and punish the wicked, Bismarck began his search for a way to harness the attacks on liberalism against the National Liberal Party and re-orient German policy in a more conservative direction. In spite of (actually because of) the anti-Catholic “cultural struggle,” the Catholic Center Party grew in voting strength after the 1873 crash. In 1878, Socialist Laws had banned the burgeoning Social Democratic party, but also did not manage to stop its rise. By 1879, Bismarck managed to realign the party politics of the Reich (the so-called “second founding”) with an alliance of the protectionist Conservative Party, the Catholic Center Party with its conservative but sometimes

³¹ Stern, *Gold and Iron*, p. 162.

³² Meier, *Entstehung des Börsengesetzes*, pp. 13-15, quote from p. 11. Rosenberg, *Grosse Depression*. Gordon Craig, *The Germans* (New York: Putman, 1969), pp. 118-119.

socially progressive agenda, and a weakened National Liberal Party that had abandoned its commitment to free trade.

In Germany, the realignment of the 1870s saw the development of three distinct strands of political economy alternatives that made German politics distinct from that of the U.S. Nearly fifty years of virtually uninterrupted Republican rule kept American populism at bay, although some Republicans were progressive and shared Democrat populist views about making big business honest. Whereas in America, those pushing for stronger, more open, transparent markets got stronger and stronger in the early decades of the 20th century, in Germany, liberals remained embattled from a number of directions. Despite the ban, the Social Democratic party developed a vision of evolutionary socialism built on unions and working class power, which terrified the propertied middle classes. A sort of milieu party politics arose linking a social class base to a party program. The three-class voting system in the states and municipalities that privileged the liberal-oriented, propertied, and notable class did permit the mental association that government policies were made by the ruling class. A distinct Catholic Center Party somewhat escaped this social class milieu politics by gathering Catholics across classes. It also had a vocal wing that developed a progressive social-oriented agenda (Catholic social thought) advocating unions and works councils, or at least a greater voice for workers inside firms to humanize bareboned capitalist relations; they also developed their own independent union movement.

Finally, some conservatives developed ideas about an enlightened, progressive civil service running key portions of the economy for the public good. Indeed, the state of Prussia operated large entrepreneurial firms such as coal mines in the Saar or nationalized railroads; it also tried to nationalize the mining firm, Hibernia, in 1904 to influence the coal syndicate's pricing policy. Municipalities also tended to own and manage public utility services. (At most, the U.S. government debated about nationalizing key firms such as AT&T in 1912, but never did.)³³

This more state-directed vision of political economy could be highly conservative (in the sense of preserving some vision of tradition) or socially progressive. Key

³³ Kenneth Lipartito and Umiko Morii, "Rethinking the Separation of Ownership from Management in American History," (unpublished manuscript).

members of the influential German New Historical School of economics, such as the conservative economist, Adolph Wagner, fundamentally rethought his position regarding economic liberalism, forging a nascent vision of a state-directed economy (“state socialism”) in the interest of preserving a healthy agrarian tradition and promoting the public good. Others such as Gustav Schmoller, found socially progressive remedies to the excesses of capitalist volatility in an enlightened civil service as a sort of generalized supervisory board for the economy, a source of social reform, and a means of managing the excesses of capitalism. The committed Anglophile liberal, Lujo Brentano, rethought his commitment to *laissez faire* by justifying cartels, unions, and tariffs in the interest of stabilizing market volatility and its potentially socially disruptive consequences. Max Weber helped provide the intellectual foundation for many progressive reforms, including the 1896 stock market laws, but in the interest of enhancing German national and economic prestige on the world stage.³⁴

Whatever the specifics of their political direction, 1873 ushered in profound consensus that capitalism needed managing; markets were potentially a source of chaos, not order. (Not until the 1950s *Ordo*-liberal school of economic theorists and Ludwig Erhard were markets re-associated with order). Exactly who, or how, or to what extent markets should be managed were heavily debated questions. This general attitude that markets needed management provided legitimacy for greater state interventions for the public good, social welfare policies, cartels, and bank intermediation of volatile stock markets. Legitimacy for greater state intervention to develop Germany had also arisen early in the nineteenth century in light of Germany’s poorly developed industrial and institutional infrastructure; Germans favored mechanisms for smoothing, supplanting, or circumventing market mechanisms. Many conservatives argued that this was necessary because markets entailed too many wasteful effects and were too impersonal, lacking the structured sense of community that characterized rural life and artisanal guilds. They were too chaotic, that is, not rationally focused, not a source of equilibrating order. According to Jürgen Kocka, one of Germany’s leading economic and business historians,

³⁴ James J. Sheehan, *The Career of Lujo Brentano: A Study of Liberalism and Social Reform in Imperial Germany* (Chicago: University of Chicago Press, 1966). Yuichi Shionoya, *The Soul of the German Historical School: Methodological Essays on Schmoller, Weber, and Schumpeter* (New York: Springer, 2005).

this attitude also helps explain why businesses quickly diversified not only into new products, but also into supply chain (distribution and raw material) expansion, and why banks took on many capital market functions.³⁵

As with most European countries, but unlike the United States, Germany had a powerful civil service headed by an aristocratic or bourgeois elite who could intervene, but in their own interests and often imbued with attitudes often described as “pre-industrial.” And they did before and after 1873, but after 1873 imbued with the legitimacy of controlling wild markets and combatting socialism. Werner Abelshauser has cogently argued that German reforms did not grow out of “preindustrial traditions” or mentalities as the classic literature of Germany’s special path argued, but that “contemporaries of the German empire were well versed in corporatist maxims, which served as models in the process of institutionally refounding the social system of production.”³⁶

Though by no means a completely unified group, German business leaders also tended to be disappointed with democratic politics. They tended to work closely with bureaucrats, with whom they felt a sense of common sense of purpose, a shared commitment to breaking down some feudal restrictions to trade. It is no wonder, wrote Peter Hayes, “that German businessmen differed from their colleagues in other countries by identifying quite closely with an authoritarian and intrusive state.”³⁷ Prior to 1913, significant power was concentrated in a royal-appointed government, not the party-based parliament, which contributed to business’s habit of working through commercial associations to express its views and to seek out remedies to its grievances within the civil service. An early version of corporatism formed before 1914.³⁸ Having suffered from a weak State and lacking a government that corresponded to German ethnic configurations, much of the German middle class’s faith in its economic future was tied

³⁵ Kocka, XXXX, p. 171.

³⁶ Abelshauser, “Umbruch und Persistenz: Das Deutsche Produktionsregime in Historischer Perspektive,” *Geschichte und Gesellschaft*, 27/4 (2001), pp. 503-523 and *Ibid.*, *The Dynamics of German Industry: Germany’s Path toward the New Economy and the American Challenge* (New York: Berghahn Books, 2005), esp. pp. 30-74, quote from p. 32.

³⁷ Peter Hayes, “German Businessmen and the Crisis of the Empire,” *Imperial Germany*, ed. Peter Hayes, et al. (Madison: University of Wisconsin Press, 1985), p. 49.

³⁸ Lothar Gall, “The Deutsche Bank from its Founding to the Great War, 1870-1914, in *The Deutsche Bank*, ed. Gall, et al (London: Weidenfeld & Nicolson, 1995), p. 78.

to dreams of a strong State, which would provide order and authority. This tendency, even in liberal circles to separate German ideology from cosmopolitan liberalism, which saw individual development as distinct from society or better in conflict with society, was reinforced by the manner in which German was unified by an authoritarian monarchy steeped in military values. This led one distinguished German historian, Leonard Krieger, to state: “Thus the limited efficacy of individual rights in their political system during the 19th century was, for most Germans, an indication not of a defect but of a distinctive German dimension to freedom.”³⁹ This also helps explain why German liberals, with some exceptions, were able to make their peace so easily with an authoritarian state and to forge a social alliance with aristocratic elites to protect both groups from competition and social democracy.

These elites managed to retain many of their privileges and much of their dominant political position. While direct government involvement in industrial enterprises and business strategies was rare, German industrialization was achieved with a political, economic, social structure and culture, in which politicians and businessmen believed that, even if ruling elites were not the parents of the birth of capitalism, they were, at the risk of over stretching the analogy, certainly the midwives. As Kocka explained:

Although German industrialization was not primarily the product of bureaucratic actions but of private entrepreneurs, and although there were many tensions between the bureaucracy and the rising business classes (especially in the most advanced western provinces of the 1840s to the 1860s), German industrialization was not achieved *against* state power but with the support of it. The bureaucratic traditions of German economic, social, and political modernization remained very visible until the middle of the twentieth century.⁴⁰

Some, like Kocka, have called the German system “cooperative capitalism,” but it might also be described as bureaucratic. However described—and historians are still debating how to describe this form of capitalism—the bottom line was that the U.S. had no comparable civil service to draw upon, let alone one with immense prestige attached to it.

³⁹ Leonard Krieger, *The German Idea of Freedom* (Chicago: University of Chicago, 1972), p. 4-5.

⁴⁰ Jürgen Kocka, *Industrial Culture & Bourgeois Society: Business, Labor, and Bureaucracy in Modern Germany* (New York: Berghahn Books, 1999), p. 76.

The crash of 1873 legitimized a greater degree of intervention or guidance in the economy for Germans.

Cartels too, for instance, were legitimized by the price deflation of the 1870s to manage markets and keep workers employed in the interest of social peace. The German cartel movement rightly began in the 1870s and 1880s (and elsewhere). Germany's leading cartel expert, Robert Liefmann, who had studied with Max Weber, could argue that cartels were more "democratic" than "monarchical" American trusts. In comparison to the "unbelievably ruthless" American practice of "throwing workers into the streets," cartels would help German firms maintain a steadier overall employment level by moderating price fluctuations. He thought this made planning more calculable, thus enhancing technological progress by reducing risk. The sheer size of trusts concentrated unprecedented financial power in the hands of few people, "in particular because anyone can get anything with money in America."⁴¹ Along with Schmoller, Liefmann's economic arguments rested on the problems of managing business cycles in a capitalist economy with salient industry sectors saddled with the problems of high fixed costs, the necessity to ensure volume or 'throughput' and long investment horizons, employment, and social costs.⁴²

Cartels had unintentional corporate governance consequences for German business. Because they tended to keep more firms in business, the rate of consolidations was slowed, permitting families or blockholders to retain majority control of corporation,

⁴¹ Robert Liefmann, *Kartelle und Trusts und die Weiterbildung der volkswirtschaftlichen Organisation* (Stuttgart: Moritz, 1910), esp. pp. 109-142. Also Lon LeRoy Peters, *Cooperative Competition in German Coal and Steel 1893-1914* (Dissertation: Yale University, 1981), pp. 44-78. Indeed, German steel firms overall employment levels did achieve steadier employment figures than American steel firms, who frequently laid off over 20% of their workforces, which was unheard of in German firms. Compare the average employment levels between 1907-1914 in Wilfried Feldenkirchen, *Die Eisen- und Stahlindustrie des Ruhrgebiets 1879-1914: Wachstum, Finanzierung und Struktur ihrer Großunternehmen* (Wiesbaden: F. Steiner, 1982), Table 104 a/b with Gertrude G. Schroeder, *The Growth of Major Steel Companies, 1900-1950* (Baltimore: John Hopkins, 1953), pp. 216-218. This difference 'proved' the efficacy of cartels for some contemporaries. Contemporaries (and some historians) claimed that cartels made German industrial growth less volatile than the U.S. or Britain, see Alexander J. Field, "The Relative Stability of German and American Industrial Growth, 1880-1913: A Comparative Analysis," *Historische Konjunkturforschung*, (Hg.) Wilhelm Heinz Schröder und Reinhard Spree (Stuttgart: Klett-Cotta, 1980), pp. 208-233.

⁴² Robert Liefmann, *Die Unternehmerverbände (Konventionen, Kartelle): Ihr Wesen und Ihre Bedeutung*, (Freiburg i.B.: J. C. B. Mohr, 1897). Literature on cartel theory can be found in Hans Merten, *Perioden der Kartellforschung in Deutschland* (Kiel: Dissertation Christian-Albrechts Universität, 1933). Walter Braeuer, *Kartell und Konjunktur, der Meinungsstreit in fünf Jahrzehnten* (Berlin: Carl Heymanns Verlag, 1934). Harry Lieser, *Kartelle und Konjunktur in ihrer wechselseitigen Beeinflussung* (Wien/Leipzig: M. Perles, 1934).

slowing the separation of ownership and control (or at least reducing over time the amount of outside investment needed for scale and scope). Instead of consolidating into larger firms, cartels slowed but did not halt the concentration process.⁴³

Finally, and perhaps most importantly, the founders' economic boom and bust coincided with the founding of the Reich so that contemporaries insistently worried about the state of their new union. The newfound Reich, already an "anxious" one, with imaginary fears bordering on paranoia against Catholics and Social Democrats, after 1873 had real reasons to worry. The relatively new phenomenon of rising unemployment heightened discussions about the "social question." Writing for about two million readers in a series of articles for the mass magazine, *Die Gartenlaube*, Glagau held forth with his characteristic mixture of sarcasm, doom, outrage and outrageousness. He prognosticated the imminent decline of the new nation if the "swindlers" were not put to justice:

The history of the foundings and issuances from 1870 to 1873 is the story of one of the most unprecedentedly large and barefaced, ingenious and intensive fraud ever committed.... How much has the German people forfeited its reputation and prestige; how quickly is its fame just achieved again paled and faded. How much has it lost of its honor and morality, on its virtue and religiosity, on its will to work and to save, on its breeding and customs! The worst and most unnatural crimes occur daily: murder and robbery, home invasions and theft make city and regions unsafe; deceit and embezzlement spread like plagues; suicide has become epidemic. Beggars and vagabonds roam around in bands; prisons and institutions of punishment are overfilled; the number of civil and criminal trials, of bankruptcies, forced repossessions, auctions, and suits are legion. Everything is a direct result of the swindle in the stock exchange and foundings. And this is again in the main the work of Jews and Semites....If all the con men of 1870-1873 would be placed before the court, there would not be enough wood in all the Bohemian forests to make the court benches.⁴⁴

⁴³ Jeffrey Fear, *Organizing Control: August Thyssen and the Construction of German Management* (Cambridge, Mass.: Harvard University Press, 2005), pp. 235-260. Jeffrey Fear, "Cartels and Competition: Neither Markets or Hierarchies," *Oxford Handbook of Business History*, (eds.) Geoffrey Jones and Jonathan Zeitlin (Oxford: Oxford University Press, forthcoming 2006).

⁴⁴ Glagau, *Börsen- und Gründungs-Swindel in Deutschland*, quotes from pp. xvii-xviii, xxii-xxiv: Die Geschichte der Gründungen und Emissionen von 1870 bis 1873 ist die Geschichte eines unerhört grossen und frechen, raffinierten und intensiven Schwindels, wie er sonst noch nicht dagewesen." [Glagau estimated losses between 700-1500 million Thaler...more than the reparations given by France...."] Was aber bedeuten diese Coursverluste gegenüber den Wunden, welche der Schwindel dem allgemeinen Wohlstand geschlagen; gegenüber der Krisis in Handel und Industrie, die seit Jahren Deutschland verheert, und deren Ende noch gar nicht abzusehen ist; gegenüber dem Nothstand, der auf dem Volke lastet, dasselbe mit Unzufriedenheit und Erbitterung erfüllt, immer grössere Schaaren der Socialdemokratie in die Arme treibt, und an verschiedenen Orten bereits Krawalle und Revolten hervorgerufen hat! Wie viel hat das Deutsche Volk an seinem Rufe und Ansehn eingebüsst; wie schnell ist der Ruhm, den es eben errungen, wieder verblasst und verblichen! Wie viel hat es verloren an Ehrlichkeit und Moralität, an Tugend und

These exaggerations bordering on a night-of-the-living-dead horror movie colored the political atmosphere of the early German Empire, apparently brought down from its illustrious heights by scheming, liberal founders. On top of this, Glagau egregiously estimated that a full 90% of all the “swindlers” were Jewish. He found refuge in purified, healthy (Protestant) nationalism against a Jewish conspiracy he found behind “Manchester” liberalism; new companies were nothing more than a shellgame for innocent investors, a bribed press that worked in cahoots with the founders, a “Jewish-liberal” judiciary, and contributed to the rise of Social Democracy—the latter also comically a result of Jewish thinking.⁴⁵

It took only a few high profile Jews such as Bleichröder, Strousberg, Rothschild, Abraham Oppenheim, or Ludwig Bamberger to prove the conspiracy. Jews, not without some reason, as they were disproportionately represented in such areas, were associated with those active in the market and in the Liberal Party (including Lasker). The hatred of the one fed neatly into the other. For many like Glagau, the stock exchange and Jews were inseparable. No less than the contemporary historian Heinrich von Treitschke, who

Religion, an Arbeitslust und Sparsamkeit, an Zucht und Sitte! Die schwersten und unnatürlichsten Verbrechen sind an der Tagesordnung, Mord und Raub, Einbruch und Diebstahl machen Stadt und Land unsicher, Betrug und Unterschlagung grassiren wie Seuchen, der Selbstmord ist epidemisch geworden. Bettler und Vagabunden streifen in Schaaren umher, die Gefängnisse und Strafanstalten sind überfüllt, die Zahl der Civil- und Criminalprozesse, der Concurse, Subhastationen und Executionen ist Legion. Alles das sind die unmittelbaren Folgen des Börsen- und Gründungsschwindels, und dieser ist wieder in der Hauptsache das Werk der Juden und Semiten. Bei der ungeheuren Mehrzahl der Gründungen sind die eigentlichen Urheber und Macher—Juden, und ihre Helfershelfer recrutiren sich leider aus allen Schichten der Gesellschaft bis hinauf zum hohen Adel und bis zu den ersten Beamten. Ihre Hauptverbündeten aber, deren Hülfe in Rath und That, deren Einfluss und Macht sie zu gewinnen wussten, waren ‘Volkswirthe’ und Parlamentarier, Literaten und Advocaten. Wie die Gründung fein einzufädeln, das Gesetz schlau zu umgehen, die Gründer vor Gefahr und Schaden, d.h. vor Verantwortlichkeit zu bewahren seien, das lehrte und zeigte der Advocat....

Manchen Gründer ereilte in gewaltsamer Tod, oder es umging ihn Geistesnacht; mancher legte selber Hand an sich, griff zum Pistol oder zum Strick, oder er ging, wie jener Banquier in Köln, den die Börsenpresse so tief betrauerte, ins Wasser...

Würden alle Schwindler von 1870 bis 1873 vor Gericht gestellt, es ware in den Böhmischen Wäldern nicht Holz genug zu den Anklagebänken!...Verlaufen die Gründerprozesse, wie es jetzt den Anschein hat, im Sande, so muss im Volke das Rechtsgefühl, der Glaube an eine prompte unparteiische Justiz schwinden, so muss die öffentliche Moral ungeheueren Schaden erleiden, Diebstahl und Betrug zu Ansehn kommen, ehrliche Arbeit und redlicher Erwerb in Massachtung gerathen, eine allgemeine Corruption Platz greifen, und das Neue Deutsche Reich unaufhaltsam dem Verfall zutreiben!!...

⁴⁵ Glagau later founded the anti-Semitic journal, *Der Kulturkämpfer*, and was later sued for libel a number of times. The fact that he appeared before Jewish judges and lost his cases only proved to him that Germany was “dominated” by Jews. See Barnet Hartston, *Sensationalizing the Jewish Question: Anti-Semitic Trials and the Press in the Early German Empire* (Leiden: Brill, 2005), esp. pp. 2-3, 56-62.

formulated the standard 19th century view of the history of the German nation, wrote in 1879 that the “Jews are our catastrophe.”⁴⁶ Although there was certainly no direct line to Hitler from 1873, Glagau’s Jewish conspiracy link between international liberalism and Marxism festered in the minds of many Germans.

Glagau was one of the highest profile journalists of the time. He represented the radical end of conservative German party politics, but his exaggerations found milder non-antisemitic versions that from this point on distinguished a healthy German capitalism distinct from *laissez faire* liberalism as well as steering it away from dangerous Marxism. After 1873 a vision of a tamer, gentler, less volatile, socially conscious capitalism arose. However vague, a vision of a ‘Third Way’ began to animate reformers. What exactly this middle road meant remained quite open and contested. Gustav Schmoller, one of Germany’s leading economists, academic social reformers (*Kathedersozialisten*), and one of the main leaders of the German Historical School wrote Lasker praising him just three days after his groundbreaking speech and *before* the great crash: “The fundamental idea that inspires us ‘academic socialists’ is none other than to fight and to eliminate the immoral, unreal, dishonest elements in our present economic conditions. And while every insider saw the excessive dirt, the excessive corruption appearing and snowballing like an avalanche so that these unfairly made types of quick fortunes nothing more than created the soil for crass Social Democracy, public opinion did not want to acknowledge all of that up to now.”⁴⁷

For decades, the memory of 1873 loomed large and motivated reforms. But the general lesson learned by reformers, the bottom line of 1873, was that markets needed better institutions and regulations to stop misdeeds, markets needed managing to tame their inherent immoderation, volatility, and attendant social costs. Or else, untamed

⁴⁶ Ogger, *Die Gründerjahre*, pp. 204-224. There is no evidence, however, that Jews were any more prone to unscrupulous activities than Gentiles. Fritz Stern’s accounts of Bismarck’s stock deals in *Gold and Iron* are enlightening in this regard.

⁴⁷ Quoted in Rosenberg, *Grosse Depression und Bismarckzeit*, p. 65: “Der Grundgedanke, der uns Kathedersozialisten beseelt ist kein anderer als der, das Unsittliche, Unreelle, Unlautere in unseren heutigen wirtschaftlichen Zuständen zu beseitigen, zu bekämpfen. Und während jeder Eingeweihte sah, dass massloser Schmutz, masslose Korruption sich überall einstellt und lawinenartig zunimmt, dass nichts so sehr als diese ungerechten Arten raschen Vermögenserwerbs der krassen Sozialdemokratie Boden verschafft, wollte die öffentliche Meinung bisher nichts von all dem zugestehen.”

capitalism would create its own upheaval. The spectre of socialism constantly haunted these reformers.

In the case of pioneering the modern social welfare state, Bismarck initiated it out of more cynical reasons and to head off the rise of Social Democracy. German reformist, progressive efforts tended to try and create better institutions, eliminate corruption, and increase social welfare provisioning. In general, though, reforms sought to soften the ruthless nature of liberal capitalism by easing social conditions and attempt to moderate the impact of business cycles in the name of establishing national cohesion and/or prestige.

In spite of clear anticapitalist sentiment among groups on the right and left, the period between 1873 and 1898 acted as a forge, incubator, or “hothouse of institutions” (Werner Abelshauser) that established the basic institutional parameters of German capitalism till this day. These include its corporate governance system (1884), its creditor-friendly bankruptcy laws (1877), its sickness and workers’ compensation programs (1883/84) and old age social insurance (1889), its stock market law (1896), the legal ruling permitting cartels (1897), and a revised national commercial and civil legal codes (1896). With the exception of cartels, almost all of the main features of the German “social market economy” at the beginning of the 21st century have their antecedents in this period.⁴⁸ One could even argue that present European agricultural protection began in this period with the reintroduction of tariffs. Even cartels, though officially banned in 1957. were born in this period.

Many *liberals* (often similar to American progressives) initiated the corporate governance and stock market reforms, such as Edward Lasker, Lujo Brentano, Max Weber, Gustav Schmoller, Adelbert Gottlieb Delbrück (supervisory chair of the Deutsche Bank)—to create better capitalist institutions to stop future scandals (corporate governance reform), to mitigate volatility (cartels)—one of the “lessons” of the 1873 crash—or to moderate markets’ ill effects (social insurance). Contemporaries engaged in a transnational dialogue of how best to tame this unruly new industrial capitalist beast and this German Historical School was immensely important to American progressive

⁴⁸ Abelshauser, “Umbruch und Persistenz, pp. 503-523 and *The Dynamics of German Industry*.

thought.⁴⁹ Only by adopting the rhetoric of the critics of 1873—another way in which the 1873 crash looms large in German history—can one interpret this simply as a “discrediting of liberalism.”⁵⁰ For instance, caricatured “Anglo-Saxon” *Manchestertum* (free trade) and, somewhat later, massive American-style trusts became the negative foil, the ‘other’ capitalism, on which to contrast healthy German economic life.

Panics!

The U.S. reaction to the 1873 “panic” highlights some important differences in this backdrop to corporate governance reform. The 1873 “Panic” in the U.S. was also traumatic, but it did not lead to fundamental reforms—indeed hardly any at all. Americans also had similar suspicions about stock promoters and speculators, but found other villains, for other reasons—and this ultimately meant corporate reform took a different direction (if one can call it that).

With impeccable timing, Mark Twain appeared with his *The Gilded Age* in 1873, a phrase that has permanently stuck to the time period. He took aim in particular at the machine politics (Boss Tweed) of American politics and the corruption of American political life brought upon by the insidious confluence of money and politics. Similar to Bismarck, corrupt cabinet secretaries surrounding Ulysses Grant also made juicy targets. Jay Cooke’s failure disclosed his behind-the-scenes influence on high level politicians. A similar scandal erupted with the corrupt ties of the Credit Mobilier to politicians and “plungers” promoting the Union Pacific. Cooke’s failure forced the New York Stock Exchange to shut down for ten days after “Black Thursday.” As in Germany, it was the worst panic until 1929; like Germany, small investors avoided the stock market for decades like the plague.

The mid-1870s in the U.S. also saw numerous bankruptcies and closures. Almost half the iron mills shut down; an estimated 20% of workers were left without employment; a railway strike in 1877 led to near open warfare in cities; a good portion of

⁴⁹ See the contributions in Martin H. Geyer and Johannes Paulmann, *The Mechanics of Internationalism: Culture, Society, and Politics from the 1840s to the First World War* (Oxford: Oxford University Press, 2001). Daniel T. Rodgers, *Atlantic Crossings: Social Politics in a Progressive Age* (Cambridge, Mass.: Belknap Press, 1998), esp. pp. 76-111. Jürgen Herbst, *The German Historical School in American Scholarship: A Study in the Transfer of Culture* (Ithaca: Cornell University Press, 1965).

⁵⁰ Rosenberg, *Grosse Depression und Bismarckzeit*.

American railroads defaulted on their bonds. The 1873 panic inaugurated a long tradition of satiric cartoons about Wall Street that also sometimes tapped into anti-Semitic themes such as with Joseph Keppler's "Shylock's Bad Bargain." The metaphor of the gambling casino also loomed large in American perceptions, but one so rigged by insiders that it was even more dishonest than a casino. American reactions to market turmoil focused on manipulation of markets and insider trading by a mysterious money trust. Wall Street was a street of sin, where investors quickly lost their money and their innocence.⁵¹

For many, the true "Crime of '73" was the elimination of the silver dollar from the coinage because an oversupply of silver meant that the value of the silver in the dollar dropped below a dollar. It did not help Cooke's reputation that he was among the most ardent "goldbugs" of the time. With the move to the gold standard by January 1879, the 1870s were also a period of deflation, which continued into the mid-1890s. Rich bankers and creditors gained at the expense of "honest" entrepreneurs carrying debt or poor farmers with fixed mortgages. For western and southern populists purporting to represent the "little man", who carried greater clout as new states were added to the Union, the "goldbugs" of Wall Street had the Washington elite in their pockets. One Texas congressman decried: "There were no beggars till the Vanderbilts and Stewarts, and Goulds and Scotts and Huntingtons and Fisks shaped the action of Congress and molded the purposes of government." Wall Street financiers and bankers were merely "usurious vultures devoid of human or patriotic sentiment." On this silver issue, William Jennings Bryan later proclaimed that honest Americans were being crucified on a "cross of gold." For many Americans, 1873 ushered in a thirty-year debate of silver agitation that would influence the writing of L. Frank Baum's, *The Wonderful Wizard of Oz*. (In the original text, Dorothy's slippers were silver.)⁵² As in Germany, tariffs too became a contentious source of debate. At Cornell, two professors had to be hired, one pro- and one anti-tariff;

⁵¹ Steve Fraser, *Every Man a Speculator: A History of Wall Street in American Life* (New York: HarperCollinsPublishers, 2005), pp. 122-151. Zimmerman, *Panic!* Ron Chernow, *The House of Morgan: An American Banking Dynasty and the Rise of Modern Finance* (New York: Simon & Shuster, 1990).

⁵² Quotes from Fraser, *Every Man a Speculator*, pp. 132-133. Also Gary M. Walton and Hugh Rockoff, *The History of the American Economy* (United States: Southwestern, 2002⁹), pp. 414-425.

the University of Pennsylvania required that its newly hired economic professor *not* support free trade.⁵³

The other issue that galvanized public opinion, but energized little practical reform was the profound effect of stock exchange panics on the U.S. banking system (if we can generously call it that) because of unit banking, patchwork state regulations, and the lack of a lender of last resort or central bank (Federal Reserve) to provide liquidity in emergencies. Although in general U.S. banks kept a healthy reserve ratio (nearly 23%), they increasingly relied on a few New York City banks to activate international transactions and count deposits held there as legal reserves. Through this informal financial web, broad-based economic changes or seasonal fluctuations were magnified and pyramided forward into New York. Working in the other direction, large bankruptcies or financial disruptions had a strong ripple effect throughout the financial world. Although a system of informal clearinghouse certificates could act as a patchwork bridge currency in an emergency, these rarely stopped the panics. Once activated the panics translated into bank and business failures, and even reduced the level of currency more, thus exacerbating the crisis. As the emigrated German, Paul Warburg, one of the architects of the Federal Reserve system, said: "The United States is at about the same point that had been reached by Europe at the time of the Medicis." Although the panic of 1873 did generate considerable discussion, according to Hugh Rockoff, the results of attempted reform were "meager." Not until the "Rich Man's Panic" of 1907 did serious discussions ensue to reestablish the Federal Reserve as a lender of last resort. One of the models was the German Reichsbank.⁵⁴

Until then, the U.S. relied on J. P. Morgan. Morgan brought "gravitas" to the stock exchange. Cleaning up the disorganized, debt-ridden railroads, he became the "Bismarck of the railroads." This ironic turn of phrase inadvertently highlights the very 'German' style of responsible bank stewardship he advocated, especially as a result of the

⁵³ Thomas K. McCraw, "American Capitalism," *Creating Modern Capitalism*, (ed.) Thomas K. McCraw (Cambridge, MA: Harvard University Press, 1997), p. 314.

⁵⁴ Hugh Rockoff, "Banking and Finance 1789-1914," *The Cambridge Economic History of the United States, Vol. 11: The Long Nineteenth Century* (Cambridge: Cambridge University Press, 2000), pp. 667-675. Paul Warburg quote from Michael A. Whitehouse, "Paul Warburg's Crusade to Establish a Central Bank in the United States," *The Region, Federal Reserve Bank of Minneapolis*, available at minneapolisfed.org/pubs/region/89-05/reg895d.cfm, accessed May 31, 2006.

1873 crash. From that crash on, Morgan learned that he would deal with and invest in only blue-chip companies, providing “development assistance to the strong,” a quality long attributed to the large German banks.⁵⁵ With the rise of big business, investment bankers increasingly supplied capital, acted as middlemen between firms and stock markets, and placed their representatives on the board of directors of firms. A very ‘German’ system of interlocking directories and banker influence on firms arose. In the intermediated world of the 19th century, such interlocking directories and bankers on board reduced informational assymetries and lowered transaction costs.⁵⁶ In 1900, both countries’ businessmen would have easily recognized their worlds. Exhibit 3 statistically describes the degree of interlocking directories among the largest corporations and banks in Germany and the United States.

⁵⁵ Fraser, *Every Man a Speculator*, pp. 151, 158. Chernow, *House of Morgan*, p. 37-38. Richard Tilly, “German Banking, 1850-1914: Development Assistance to the Strong,” *Journal of European Economic History*, 15 (1986), pp. 113-152. *Idem*, “An Overview on the Role of the Large German Banks up to 1914,” *Finance and Financiers in European History, 1880-1960*, (ed.) Youssef Cassis (Cambridge: Cambridge University Press, 1992), pp. 92-112.

⁵⁶ De Long, “Did J.P. Morgan’s Men Add Value?.” Charles W. Calomiris, “The Costs of Rejecting Universal Banking: American Finance in the German Mirror 1870-1914,” *Coordination and Information*, (eds.) Naomi Lamoreaux and Daniel Raff (Chicago: University of Chicago, 1995) pp. 257-321.

Exhibit 3:
Banking Networks of Largest Firms in the United States and Germany 1896-1938
(U.S./German)

Dimension	1896/1900	1914	1928	1938
Number of Largest Firms	249/212	242/323	369/377	409/361
Stand-alone Firms (non-interlocked) (%)	9.2/26.4	20.2/9.6	10.8/2.9	8.3/4.2
Weakly-linked Firms (1-2 interlocks with other firms) (%)	19.3/28.8	21.1/15.8	16.3/2.9	19.6/6.9
Avg. Size of Board of Directors	13.3/7.9	14.4/12.7	17.5/21.7	16.5/15.0
Total Number of Interlocks	1579/513	1466/3081	2538/12374	2091/6967
Avg. Interlocks per Firm	6.34/2.42	6.05/9.54	6.88/32.8	5.11/19.3
Density of Network*	3.2/1.61	3.34/4.23	2.49/10.8	1.64/7.0
No. of Directed Interlocks only #	468/136	395/438	812/1416	715/1156
Multiple Directed Interlocks (%)	12.4/5.1	10.9/7.5	10.6/15.3	8.5/14.9
Avg. Directed Interlocks per Firm	1.88/0.64	1.63/1.36	2.2/3.76	1.75/3.2
Number of Banks in Sample	46/30	49/47	62/59	77/47
Directed Banking Interlocks to Industrial Firms	122/76	137/207	258/426	262/252
Avg. Directed Interlocks per Bank	2.7/2.5	2.8/4.4	4.2/7.2	3.4/5.4
Industrial Firms with Banker on Board (%)	32.5/25.3	36.2/40.9	43.0/59.4	46.1/48.4
Industrial Firms with 3+ Bankers on Board (%)	6.9/3.8	8.3/7.2	11.4/18.9	7.5/7.6
Banker as Chairman/President (%)	2.5/13.7	2.1/14.5	8.5/23.0	10.2/24.8

Source: Paul Windolf, "Unternehmensverflechtung im organisierten Kapitalismus: Deutschland und USA im Vergleich 1896-1938, Tables 1 and 4, available at www.uni-trier.de/uni/fb4/soziologie/apo/netzwerk1896.pdf. U.S. 1900; Germany 1896.

*Density of Network means the ratio of actual interlocks to the potential total ones available.

#Directed interlocks signify that a member of the executive board of Firm A holds a position in the supervisory firm of Firm B; undirected interlocks mean that a person sits on the supervisory board of Firms A and B. The distinction measures the degree of intentionality and potentially the tightness of control over another firm.

Based on these figures, around 1900 one might argue that the U.S. had the more "organized capitalism" and bank-based economy, but by 1928 Germany evolved many of the attributes that have held until the 1990s. In 1896, over 25% of large German firms had no interlocking directories as opposed to just 9% of American firms, but these figures nearly reversed by 1914; by 1928 just 3% of the largest firms in Germany were

completely independent. The percentage of firms in both countries with 1-2 interlocks were roughly comparable in 1914, but diverged dramatically by 1928. A striking result is that German firms had smaller boards of directors in 1900 than American ones, but average German board sizes surpassed American boards by 1928. Also the average number of interlocks per firm were three times less in Germany around 1900, yet were nearly five times the American average in 1928; the density of the interlocking network was two times as high in the U.S. in 1900, but reversed to five times as high in Germany in 1928. Executive directors sat on other firms' boards to a greater extent in the U.S. in 1900, roughly comparably by 1914, but they grew steadily in Germany by 1928.

Most counterintuitively, however, was the role of banks, which were *more* present in American firms in 1900, roughly comparable in 1914, but dramatically made their presence felt by 1928 in Germany. In particular, the fact that nearly one-quarter of the largest German firms had a banker as supervisory board chair indicates the significant role that bank ties played in German capitalism. It would take us too far afield to discuss the heavily debated role of *Finanzkapital* in Germany, but suffice it to say that it is difficult to generalize about the power of banks from their presence alone on boards. For one, the fact that they had more than one banker in their supervisory boards—and most often from different banks—means that firms could potentially play banks off one another. The ironic aspect of this statistical strengthening of bank presence came precisely at the time when banks were dramatically weakened after the hyperinflation and could not support industrial ventures as well in financial terms; many German firms had to turn to American markets to raise capital.⁵⁷ Still the figures do show that German “coordinated capitalism” or Deutschland AG began to take shape prior to 1914, but was comparable to the U.S.; it was more “coordinated” or “organized” after the 1920s. The true divergence begins with World War I.

The statistical structure and economic or information cost reasons for relationship banking, however, fails to capture the strikingly different *attitudes* toward bankers and

⁵⁷ Caroline Fohlin finds little correlation between the rise of banks on boards and their relative power or influence, see “The Rise of Interlocking Directorates in Imperial Germany,” *Economic History Review*, 52/2 (1999), pp. 307-333. Volker Wellhöner, *Grossbanken und Grossindustrie im Kaiserreich* (Göttingen: Vandenhoeck & Ruprecht, 1989). Harold Wixforth, *Banken und Schwerindustrie in der Weimarer Republik* (Köln: Böhlau, 1990).

banking relationships between the U.S. and Germany (discussed more specifically in Section II.b regarding banks' role in boards of business firms and in Section II.c regarding banks' role in capital markets). Before 1914, in structural terms and in their suspicions about speculation, the two countries were not all that different, but in terms of their attitudes towards markets, cartels, banks, central banks, and stock exchanges they remained oceans apart.

Nowhere can this difference be seen more clearly than with the passing of the 1890 Sherman Anti-Trust Act, *the* symbol of Americans distrust of big business and concentration of power. Although not immediately enforced until the Knight trial of 1894, it ushered in a wave of anti-competitive legislation culminating in the Clayton Act of 1914 designed to counteract this insidious concentration of economic power. American anti-trust legislation was ironically ostensibly directed against “trusts” such as the Rockefeller oil empire, but most effectively curbed the growth of price-fixing agreements among firms, that is, cartels. Germans not only legally sanctioned cartels on grounds that they helped stabilize industries in bad times (“parachutes”), but as an anti-trust or anti-monopoly measure since they blocked or slowed concentration into one big firm. American distrust of economic concentration also eventually focused on the power of the big Wall Street banks on American life. For instance, most states remained largely committed to unit banking in order to block greater concentrations of power, began to legislatively limit the influence of banks over industry, and eventually prohibited universal banking entirely with the Glass-Steagall Act of 1933.⁵⁸

The other major U.S. debate centered on the money supply and the need (or not) for a Federal Reserve, which was a moot point in Germany. While Americans certainly found enough villains, speculators, “moneycrats,” and “robber barons” in their midst—particularly *bankers* and stock market tycoons—financial crises became a sort of inexplicable, frenzied, hysterical, collective “panic,” an exercise in irrational crowd psychology more or less manipulated by insiders belonging to a mysterious, dark “money

⁵⁸ The German liberal, Lujo Brentano, used the term, “parachute.” The cross-cutting intentions, measures, and implications are contrasted in Fear, *Organizing Control*, pp. 235-260. Jeffrey Fear, “German Capitalism,” *Creating Modern Capitalism: How Entrepreneurs, Companies, and Countries Triumphed in Three Industrial Revolutions*, (ed.) Thomas K. McCraw (Cambridge, MA: Harvard University Press, 1997), pp. 135-182. Thomas K. McCraw, *Prophets of Regulation*. Mark Roe, *Strong Managers, Weak Owners, Strong Managers*.

trust.” Sunshine was the best remedy. In Louis Brandeis’ immortal words: “Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.” The final passage of the legislation establishing a new central bank in the U.S. required not only further panics and advice from German financial leaders about the benefits of the Reichsbank model, it also required convincing many populists and progressives that centralized banking was inevitable and that putting it in the hands of the government was clearly the lesser of two evils.⁵⁹

Germans, however, found their villains in “founders,” shareholders without scruples and no stake in firms as a solid, productive, ongoing entities; such stock manipulators duped or fleeced innocent investors who dared to place their money in firms barely worth the paper they issued with their names on the header. Someone needed to shield investors from their inexperience and ensure only honest firms appear on the stock exchange. That role increasingly fell to bankers as responsible “stewards” and screeners of the respectable industrial firm. For instance, Jacob Riesser, head of the influential Central Association of German Banks and Bankers (*Centralverband des deutschen Bank- und Bankiergewerbes*), thought that small investors should responsibly stay away from the fluctuations of shares. Although J. P. Morgan essentially made a very German argument for responsible bank stewardship of the economy, American populist distrust of bankers safely using “other people’s money” eventually eliminated such a solution. By 1913, in essence the German business system was successfully “Morganized”—and that was largely considered good, not bad, as in the U.S. Paradoxically, the establishment of the Federal Reserve could be viewed as a means of taking power out of the hands of private bankers. The founders’ crash proved to many Germans that cutthroat capitalism could not work. For Germans, relationship banking brought “gravitas,” influence (often viewed problematically), stability, and cooperation.

We should not exaggerate, however, the positive view of bankers in Germany as opposed to banks as institutions if they supported “productive” industrial enterprises. The widespread perception of banks in Germany was that of an an “unproductive” venture: “The class of bankers is only useful and necessary insofar as the serve the productive work.” In the words of Theodor Fontane, bankers “unconditionally ruled on

⁵⁹ Richard Hofstadter, *The Age of Reform: From Bryan to FDR* (New York: Vintage Books, 1955).

the stock market, but only conditionally in society.” Even German entrepreneurs were a little ashamed of their money-making activities. One of the unique and powerful aspects of the German *Bürgertum* was the distinction between an “economic elite” (*Wirtschaftsbürgertum*) and a “cultured elite (*Bildungsbürgertum*) that retained its immense prestige, being associated with intellectual spirit (*Geist*), rather than mere money-making activities. Unlike Americans, many of whom had made the long journey from their homes for the precise reason of making money, Germans, while recognizing the utility of the industrial achievements of the Krupps, Siemens, and Borsigs, tended to find the pursuit of money for its own sake as a poison to society and an affront to the spirit. German literature is replete with examples of how money making as opposed to work, or more precisely craftsmanship, degrades people, and stultifies artistic genius and culture.⁶⁰ What distinguishes, perhaps, German artistic expressions about business is the degree to which pre-industrial forms are held up as a model and financial middlemen are portrayed as craven creatures. Consider Freytag’s mid-nineteenth century classic novel, first published in 1855, *Soll und Haben* (Debit and Credit), which for decades was one of the most popular books in Germany, a veritable hymn to orderly *petite bourgeois* society, in which tradesman realized themselves through work under the watchful eyes of wise and caring aristocrats, who preserved order and spiritual values against those who would turn business into “a monetary affair.” Social sanctions against strictly profit-oriented motivations and economic success were not strong enough to prevent entrepreneurial behavior, but, nevertheless, they helped shape the attitudinal and institutional context of commercial behavior.⁶¹

The founding of the Central Association of Banks and Bankers was in part driven by the poor reputation of bankers. Among the Social Democrats, they represented a hidden monied elite dominating firms, which eventually found expression in Rudolf Hilferding’s *Finanzkapital*. Unlike England with its close alliance between the old and new elites, bankers formed an economic elite, but had difficulty as a social and political

⁶⁰ See Gordon Craig, *The Germans* (New York: Putman, 1969) 116-117. The contrast between anti-business references in German and American literature is quite striking. Insofar as materialism harmed society, in German literature and music (*The Rhine Gold*), it harmed the soul, critiques of capitalism focused on the power of some to impede others from attaining their economic goals.

⁶¹ Jürgen Kocka, *Industrial Culture & Bourgeois Society: Business, Labor, and Bureaucracy in Modern Germany* (New York: Berghahn Books, 1999), p. 87.

elite forming alliances with the old aristocratic elite. Among aristocrats and political conservatives, bankers remained too liberal, parvenu, and too Jewish. A good deal of the conservative (in an economic and personal sense), *bürgerlich* image as stewards cultivated by elite bankers was designed to counteract these suspicions, which made bankers an fairly homogenous social elite in terms of their social *habitus* and personal carriage. Bankers became a bastion of liberal *Bürgerlichkeit*. Bankers' image also became immensely important for legitimizing their activities and raising their own social status.⁶²

Yet in spite of suspicions, close banking relations with firms and their implicit screening and vetting role in founding new firms—a product of 1873—Germans viewed such banking relations as necessary evil—even if they distrusted bankers. Banks were at least better than the stock market; they permitted good industrial firms from being traded like commodities on the immoral casino of the stock market. Many entrepreneurs such as August Thyssen could work closely and cooperatively with many bankers, as long as they did not try to intervene in his business, but refused to entertain the idea of listing or issuing shares on the stock market.⁶³

In the U.S., however, J.P. Morgan made very German arguments about banks as a source of order, stewardship, and support, but suspicions of this inside “money trust” diluted banking power, esp. after 1914. The basic schizophrenia of U.S. financial life was its effective reliance on Wall Street investment bankers as an implicit central banker whom it really did not like or trust. Wall Street had such a poor image on Main Street that Paul Warburg declined the first offer to head the Federal Reserve because of the “rampant prejudice in this country against a Wall Street man;” Warburg had worked at Kuhn, Loeb and Co.⁶⁴ Precisely because of this heavy reliance on investment bankers' leadership, a “money trust” of insiders resulted that was subsequently skewered in the

⁶² Reitmayer, *Bankiers im Kaiserreich*, esp. pp. 274-299, 345-363; quotes from p. 274, 352. Hartmut Berghoff and Ingo Köhler, “Redesigning a Class of its Own Social and Human Capital Formation in the German Banking Elite, 1870-1990,” (unpublished manuscript). Recent literature has overturned the idea of feudalization and a social alliance among the business elite and aristocracy, see Jürgen Kocka, “The European Pattern and the German Case,” *Bourgeois Society in Nineteenth-Century Europe*, (eds.) Jürgen Kocka and Allan Mitchell (Oxford: Berg, 1993), pp. 3-39. Kocka still argues that the German *Bürgertum* was relatively weak in an international perspective; the major difference lay in its symbiosis with and high prestige of the civil service and state.

⁶³ Fear, *Organizing Control*.

⁶⁴ Whitehouse, “Paul Warburg's Crusade.”

Pujo Committee report of 1913. Except for the boom and bust cycle of 1873, the German stock market and economic growth was not as volatile as the American one because of the Reichsbank's role of lender of last resort and inter-bank cooperation. Germans desired insiders to tame, stabilize, and make capitalism respectable.

In the U.S., the assumption was that markets should work effectively if people either did not lose their heads in a panic or if evil speculators could not work their misdeeds in the dark. The U.S. evinced a strange mixture of Christian messianism combined with Adam Smith's condemnation of urban merchants as insiders and market manipulators. This was the major difference in attitudes and perception between the dominant American ideology and that of Germans. In Germany, markets were indeed necessary but inherently volatile, needed taming by countervailing institutions, and made to be stable and respectable by responsible stewards—a role that fell to banks, paradoxically, in spite of suspicions regarding bankers.

The next two sections detail how banks became anchored in German corporate governance and as intermediaries on the stock market.

Iib. Making Foundings "Solid:" The 1884 Joint-Stock Company Law

Discussions about reform of joint-stock company law began almost immediately following Lasker's speech. The *Verein für Socialpolitik*, founded in 1872, which assembled Germany's top economic intellectuals, made the first 1873 volume in their famous research series about the need to reform joint-stock companies. According to the Association of German Lawyers (*Deutsches Justiz-Tag*) reforms should above all "prevent unsolid foundings or abuses in the administration of joint-stock companies." According to the Prussian Commerce Minister the main problem was that founders started up new companies only as a means to make a profit, then cashed out. The legal historian, Peter Hommelhoff, concurred. Corporate law reform after 1873 was designed to counteract the fraudulent or frivolous creation of companies as mere "stock exchange commodities" (*Börsenware*) by unscrupulous founders or shareholders, who sold out as soon as they could take their profits. Insiders also sold their stock more quickly, leaving outside investors holding *Pfennigs* on their investment.

The founder's crash cemented the attitude and image of shareholders, not as venture capitalists or heroic owner-entrepreneurs, but as mere speculators, let alone potential cheats. The intention to protect the long-term "objective needs of the enterprise" from the short-term, profit-taking of disinterested, potentially dangerous shareholders ran like a "red thread" through the history of German corporate law, according to Hommelhoff. The Nazis enshrined an extreme version of this attitude in its corporate law of 1937 that essentially made shareholders parasites on the body of the corporation as cell of the national economy.⁶⁵

This fundamental attitude permeated German corporate governance in ways that tended to protect the enterprise as an ongoing concern rather than protect investors as in the U.S., although the 1884 company law certainly did strengthen shareholder protections. Indeed, one of the main goals of the reform was to make the shareholders' general assembly the ultimate decision-maker. In theory, shareholders were the ultimate arbiter for the firm, which in practice did not quite work in the intended way for reasons discussed below. In this respect, the Nazi 1937 law violated a fundamental principle invoked by the 1884 company law, which strengthened shareholder rights especially vis-à-vis (dishonest) promoters.⁶⁶ Until Nazi-sanctioned total managerial control, German reformers bounced between the poles of too much "Smithian" *laissez faire* or too much prescriptive regulatory control, which played itself out in the debate about corporate governance reform.

The 1884 company law successfully avoided greater state supervision (Wagner) by strengthening "self-control" (*Eigenkontrolle*) by counterbalancing private interests in the three main "organs" of the joint-stock company: executive board, supervisory board, and general assembly. In spite of horrific public outcries about the future of Germany from figures such as Glagau, or attempts to outlaw the joint-stock form altogether, or nationalizing or founding state-owned enterprises to counteract private monopolies along with public supervision of large corporations such as advocated by Wagner, cooler heads

⁶⁵ Peter Hommelhoff, "Eigenkontrolle statt Staatskontrolle—rechtsdogmatischer Überblick zur Aktienrechtsreform 1884," *Hundert Jahre moderenes Aktienrecht* (Berlin: Walter de Gruyter, 1985), p. 56. Also Werner Schubert, "Die Entstehung des Aktiengesetzes vom 18. Juli 1884," *Hundert Jahre moderenes Aktienrecht* (Berlin: Walter de Gruyter, 1985), pp. 1-13, quote from p. 6.

⁶⁶ See esp. Hommelhoff, "Eigenkontrolle statt Staatskontrolle," pp. 87-102.

prevailed in the commission appointed to reforming German corporate governance. Liberal incorporation laws were essentially retained, but the reforms strengthened the role of banks, dedicated shareholders, or other firms on German supervisory boards. The ultimate goal of reforms was to create “full transparency and responsibility” (“*voller Oeffentlichkeit und Verantwortlichkeit*”) particularly in regards the founding of new firms.⁶⁷ The solutions proved highly robust, laying the foundations for German corporate governance until the 1990s.

The debates surrounding corporate governance reform were surprisingly modern, sensible (even if one could debate their finer points or disagree with the solution), and broached classic, sensitive issues of corporate governance. They argued about issues about how prescriptive and detailed regulations could become before constraining entrepreneurial freedom too much. The Reich’s Imperial Court stressed that complicated, detailed rules would only raise the costs of business, particularly in a depressed time that needed to see an economic upswing. How much liability should board members have? How could one differentiate dishonest abuse from poor business judgment? How independent should supervisory board members be and how much influence should they have over the executive board? Should there be independent audits and who should carry them out, and how often? How much should the state be involved with setting standards? Or how much should autonomy should business have to establish their own professional rules? Should there be one-share, one-vote or should the law continue to permit non-voting shares or preferred shares? Should a required reserve fund be established or should all profits go to shareholders? Some thought no amount of rules could save people from unethical entrepreneurs or from their own greed or inexperience as investors; proscribing too many rules would never be sufficient.⁶⁸

The key commission established in 1882 to sort these issues out tried to find a balance between the two extremes. The commission consisted of a number of business luminaries (such as Adelbert Delbrück of the Deutsche Bank; Richard Koch, later Reichsbank President, or Emil Russel, director of the Berliner Disconto-Gesellschaft),

⁶⁷ Schubert, “Die Entstehung des Aktiengesetzes,” p. 5, from *Verhandlungen des Vereins für Socialpolitik*, 12-13. Okt. 1874, Schriften des Vereins für Socialpolitik, Bd. IV.

⁶⁸ The discussion is based on Schubert, “Die Entstehung des Aktiengesetzes,” pp. 7-52; all quotes here.

academics (Adolph Wagner, Hermann von Sacherer, Levin Goldschmidt), and slew of government officials. A full discussion cannot be attempted here, but a few of the main debating points highlight key attitudes that shaped this crucial law.

One of the liveliest debates regarded minimal share prices, which bounced up and down between a suggested 1000 and 5000 Marks. Some recommended minimal shares as high as 5000 Marks to “protect small investors” from themselves. It would also help prevent the founding of subquality firms that damaged the whole economy; only serious firms would be founded. In Parliament, left-liberal and national liberal parties thought they detected a certain “spirit of suspicion and mistrust” in regards the joint-stock company. They complained that minority protections and the liabilities of directors were too high. Banks issuing shares were also held liable for any dishonest dealings during the startup phase. Another parliamentarian warned about the creation of a potential “fee-oriented and clique-based system” on boards. Delbrück of the Deutsche Bank criticized the law as being “mistaken” (*verfehlt*), “distant from practice,” and granting too many powers to the “dead capital” of the general assembly. He objected to the law declaring the totality of shareholders of the general assembly as the ultimate decision-maker for the firm (*Willensorgan*). The wealth of nations, he said, was not made up by the “fullness of property,” but by the “fullness of the acquiring powers” (*erwerbenden Kräfte*). Another official thought that with all the protections against abuse in boards, all the new regulations simply moved the “unscrupulousness” to the backrooms of the shareholders or their “dark” representatives, which would make the company the “game ball of the most dishonest interests.”

The 1884 law did strengthen key shareholder protections. Especially through the supervisory board and shareholders’ meeting, shareholders could alter company statutes or hire and, most importantly, hire and fire executive board members, one of the key new powers of control of the supervisory board over management. Corporate governance reformers also drew the conclusion to strengthen the supervisory capacity of the supervisory board, while circumscribing their executive activities. It delineated more closely supervisory board responsibilities, including prohibiting them from intervening in day-to-day decision-making; the supervisory board could also call for special corporate audits with a majority. Individuals could not be present on both boards simultaneously.

Shareholder control was asserted primarily by their annual election of their representatives to the supervisory board. Another basic idea was to strengthen managerial autonomy from activist, meddling shareholders merely out to maximize their short-term dividends in the interest of the ongoing concern. While each individual shareholder had the right to appeal or contest stipulations, certain share proportion thresholds limited small investor activism. Over time—and inadvertently—this supervisory board representation of shareholder interests strengthened the influence of banks on board.

The 1884 joint-stock law ultimately raised minimum par value of shares to 1,000 Marks (USD 240 at the time, but equal to roughly USD 40,000 in today's dollars) in order “to protect small investors, who cannot judge the business condition and management of a joint-stock company, from participating in it and potentially losing their savings.” Only other companies or the relatively rich could buy stock. The state essentially evoked a paternalistic act to protect its less rich citizens, but, along with other measures, this helped dampen equity markets in favor of credit-based banks.⁶⁹

The thrust of corporate law reforms (and stock market reforms, discussed below) encouraged long-term investment in and commitment to manufacturing companies, reflecting German discomfort with impersonal capitalism. They and this corporate governance law evinced a general preference for what one economist has called voice and loyalty (working to inside institutions to influence their behavior) to exit (simply disengaging).⁷⁰ German corporate governance seemed to be designed to concentrate power so that a small number of dedicated and respectable entrepreneurs, managers, and financiers—prior to 1914 to a large extent personally connected with one another and increasingly concentrated in Berlin—could responsibly steer a “productive” economy, which was becoming technologically and organizationally ever more complicated, let alone beset by conflicting social pressures. As shown above, large universal banks increasingly played an important role in the supervisory boards of most German firms.

⁶⁹ Quoted in Eube, *Der Aktienmarkt in Deutschland*, 36; on the important 1896 Exchange Act, see 43–49. For greater detail, see Hommelhoff, “Eigenkontrolle statt Staatskontrolle.” The book reproduces the individual drafts and revisions of the law in detail.

⁷⁰ Albert O. Hirschman, *Exit, Voice and Loyalty* (Cambridge, Mass.: Harvard University Press, 1970)

Their influence over German industrial firms and general efficacy is one of the most heavily debated areas of German business history.⁷¹

We cannot discuss this here, but crucial for our argument is not the relative power of banks in Germany or the U.S. (though we must remind readers that no German bank exercised the power of a J.P. Morgan), *but that German banks could resort to a legitimizing ideology justifying their presence in German firms in the name of corporate and social stability*, however suspicious they remained about bankers. In fact, the classic works about German banks appear just after the turn-of-the-century to combat such suspicions. A significant ‘populist’ strain against the power of the large Berlin banks in the German economy from both the right (mostly Mittelstand entrepreneurs or provincials

⁷¹ Still useful classic works on German banking are Jacob Riesser, *Die deutschen Großbanken und ihre Konzentration* (Jena: Gustav Fischer, 1910); in English, *The German Great Banks and their Concentration* (Washington, D.C.: Government Printing Office, 1911). Otto Jeidels, *Das Verhältnis der deutschen Großbanken zur Industrie* (Leipzig: Duncker und Humblot, 1905). Rudolf Hilferding, *Finance Capital: A Study of the Latest Phase of Capitalist Development* (London: Routledge, 1981 [1910]). For an early critical view contradicting the power of the banks on supervisory boards, see the neglected Richard Passow, *Die Aktiengesellschaft: Eine Wirtschaftswissenschaftliche Studie* (Jena: Gustav Fischer, 1922), esp. pp. 387-461. Modern assessments begin with the classics Alexander Gerschenkron, *Economic Backwardness in Historical Perspective* (Cambridge Mass.: Harvard University Press, 1962). Rondo Cameron, *Banking in the Early Stages of Industrialization* (Oxford: Oxford University Press, 1967). Recent works stressing the important interdependency of universal banks and heavy industry, see Richard Tilly, “On the Development of German Big Banks as Universal Banks in the 19th and 20th Centuries: Engine of Growth or Power Block?” *German Yearbook on Business History* 1993 (München: K.G. Saur, 1994), pp. 110-130. *Idem*, “Banking Institutions in Historical and Comparative Perspective: Germany, Great Britain and the United States in the Nineteenth and Early Twentieth Century,” *Journal of Institutional and Theoretical Economics*, 145 (1989), pp. 189-209; *idem*, “German Banking, 1850-1914: Development Assistance to the Strong,” *Journal of European Economic History*, 15 (1986), pp. 113-152; *idem*, “An Overview on the Role of the Large German Banks up to 1914,” *Finance and Financiers in European History, 1880-1960*, (ed.) Youssef Cassis (Cambridge: Cambridge University Press, 1992), pp. 92-112. Wilfried Feldenkirchen, “Banking and Economic Growth: Banks and Industry in Germany in the Nineteenth Century and Their Changing Relationship during Industrialisation,” *German Industry and German Industrialisation*, (ed.) W. R. Lee (London: Routledge, 1991), pp. 116-147. A widespread revision about the power and role of German banks is underway. Volker Wellhöner, *Großbanken und Großindustrie im Kaiserreich* (Göttingen, 1989). Dietmar Petzina (Hg.), *Zur Geschichte der Unternehmensfinanzierung* (Berlin: Duncker & Humblot, 1990). Harald Wixforth, *Banken und Schwerindustrie in der Weimarer Republik* (Köln, 1995). Jeremy Edwards and Klaus Fischer, *Banks, Finance, and Investment in Germany* (Cambridge: Cambridge University Press, 1994). Harold Wixforth and Dieter Ziegler “Bankenmacht: Universal Banking and German Industry in Historical Perspective,” *The Evolution of Financial Institutions and Markets in Twentieth-Century Europe*, (eds.) Youssef Cassis, et. al. (Brookfield: Ashgate, 1995). Caroline Fohlin, “Relationship Banking, Liquidity, and Investment in the German Industrialization,” *Journal of Finance*, V. 53 (October 1998), pp. 1737-1758. Jeremy Edwards and Sheila Ogilvie, “Universal Banks and German Industrialization: A Reappraisal,” *Economic History Review*, 49, 3 (1996), pp. 427-446. Caroline Fohlin, “The History of Corporate Ownership and Control in Germany,” *A History of Corporate Governance around the World: Family Business Groups to Professional Managers*, (ed.) Randall K. Morck (Chicago: University of Chicago Press, 2005), pp. 223-277 along with a series of articles listed here and her forthcoming book. Gerald Feldman, XXX.

feeling neglected) or from the left, viewing it as *Finanzkapital* domination and proof of inevitable capitalist concentration in the Marxist vein. In the U.S., too, universal and investment banks played a key role in resolving fundamental dilemmas pertaining to information asymmetries, transaction costs, and trust, but in the U.S. there was little legitimizing ideology, except the self-serving ones put forth by bankers such as J. P. Morgan. A “money trust” of insiders found little general acceptance of its functions.

J.P. Morgan and his colleagues were in many respects ideal monitors of business enterprises for Germans. They controlled large shareholdings and made long-term commitments to their clients, and at times even performed more direct public service for the nation. But whereas Morgan’s activities might have been praised for creating stability and furthering the long-term interest of enterprises in Germany, they were vilified in the United States. Likewise most Germans revered their great German industrialists, some of whom were even benighted. However, in America the Rockefellers, Carnegies, and Vanderbilts were for most Americans merely Robber Barons, who threatened the economic vitality, political liberty of the nation, and above all the sacred economic opportunity of the common man.⁷²

Most agreed with Karl Helfferich, when he wrote that in the face of enormous capital needs, shortages of capital for Germany’s great advances in technical, industrial development during the 25 years preceding World War I, German banks had succeeded in “keeping the proper balance between intensive capital employment and fundamental security.”⁷³ Part of that balance lay in preserving independent companies, coordinated by large industrial organizations like cartels, syndicates or communities of interest (*Interessengemeinschaften*), which had, according to Helfferich, many of the benefits of the large American Trusts, such as limiting production, but avoided “the chaotic competition” and economic waste and tensions inherent to “unplanned” commercial endeavors.⁷⁴

As financial advisors, market makers, and members of *Aufsichtsräter*, they could provide investors with an acceptable tradeoff between security, liquidity, and overall

⁷² For a discussion of attitudes about Morgan and Rockefeller, see Ron Chernow, *The House of Morgan* (New York: New York: Touchstone, 1991) and his *Titan* (New York: Random House, 1998).

⁷³ Karl Helfferich, *Deutschlands Volkswohlstand 1888-1913* (Berlin: Georg Stilke, 1915) 44.

⁷⁴ *Ibid.*

returns by controlling both markets and companies. Even though separation of banking activities was proposed in Germany long before the Glass-Steagall Act of 1933 was passed in the United States, it was rejected because Germans because, by and large, they felt comfortable with the role of banks as an acceptable antidote to instability, corporate volatility, and a means of achieving balanced economic growth. As Richard Tilly wrote of the change in the role of banking in German corporate governance:

Finance (in Germany) is a matter of small-group negotiation rather than the reading of anonymous price signals, and it frequently reflects banker initiative. ‘Universal banking’ – union of commercial and investment activities—had banks closely monitoring their customers’ activities, sometimes controlling the latter, always treating the relationship as an ongoing (long-term) one.⁷⁵

This role of banks, moreover, contributed to many political goals of the state and consistent with many other measures taken after 1873 to protect society from the effects of industrialization such as more proscribed rights for workers, nationalization of some important industries, higher tariffs on many goods, cartelization of much of German industry, and increased pressure on banks to moderate the harsh effects of capitalism by lending even through hard times—one of the key alleged virtues of relationship banking.⁷⁶

German banks were tied to the government in many other ways that American banks were not. Even though the major money center banks in the U.S. at times performed public functions, neither the banks nor government felt comfortable with the confusion of public and private objectives. Like its prototype, *Crédit Mobilier de Paris*, *Deutsche Bank* began life with a social project as well as to finance exports—one of the main ways Germany asserted itself on the world stage before 1913—and in the 21st. *Deutsche Bank*, which became the biggest bank not only in Germany but the world shortly before World War I, was set up in order to further German interests abroad in a way that private banks, its original principal shareholders, could not and rose to prominence based on its usefulness not only to industrial interests but also to government

⁷⁵ Tilly, 110.

⁷⁶ Cartels, by and large, failed to achieve price stability and capital markets were never fully insulated from speculation and panic.

policies. It also cooperated with the government to root out speculative profits and abusive transactions in the stock market, such as buying stocks at their face value and reselling them to the market at a higher price.⁷⁷

By holding deposits and investing in corporations, Deutsche Bank and the other German universal banks, served as a useful bridge between investors and industry that seemed to be in everyone's interest. The otherwise intolerable mismatch of deposits with risky industrial investments inherent to banking was also somewhat mitigated by the wise, steady investment guidance of the universal bankers, who advised both the users and the providers of loanable funds. Having shown restraint during the boom, Deutsche Bank was in a good position to turn its attention to domestic financing, transforming itself into a universal bank with large amounts of deposits, current account transactions, as well as issuing new public and private securities. Though its position as trusted financial advisor and effective control of some industries was not without controversy, Deutsche Bank became the house bank to a number of Germany's most important companies. The bank's discouraging consolidation of companies and encouraging of cartel arrangements, which were designed to keep smaller companies afloat, were welcomed in most circles as a stabilizing influence. Along with cartels, banks were viewed as the great stabilizers of German capitalism.

As in the United States, banks took an active role in corporate management, but in contrast to the United States, this development was not accompanied in Germany by public outrage until the economic and political crises following World War I. The banks with their seats and active participation on supervisory boards preserved the personal dimension of capitalism that many Germans liked about entrepreneurial firms. Although conflicts arose between firms banks and the firms, who not always passive customers, not even the conflict of interest between the banks *qua* shareholder and the banks *qua* creditor elicited much interest in public and governmental circles until World War I.

The inevitable conflicts of interest between the bank's role as overseer and principal seller of financial services was hardly questioned during prosperous periods, as it was seen as an acceptable price, agency cost, of effective social and economic control of firms, but *bankers* knew that they had to foster an image of reliability, social

⁷⁷ Gall, 1-24.

consciousness, and high cultural prestige (such as with philanthropy or support of the arts). (To this day, the Deutsche Bank has one of the largest art collections in the world, which makes no sense from a purely functional economic viewpoint.) Banks took risks as venture capitalists in new Second Industrial Revolution firms, but their responsibility as the public trustee of capitalism weighed heavily on bankers, who worked hard on public relations campaigns to dissociate themselves from the evils of the stock market.⁷⁸

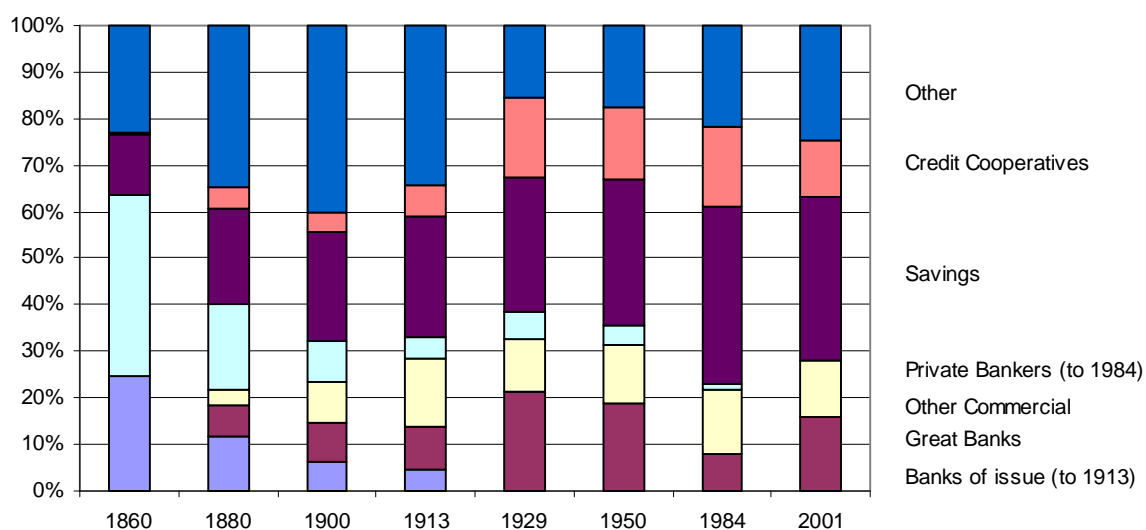
The Central Association of the German Banking and Bankers Trade, for instance, was established in 1901 to counteract the public concern about investment and to educate the public about the role and profession of banking. The association's house journal, *The Bank Archiv*, as well as other journals praised banking for its national consciousness and responsible oversight of industrial development. These efforts were relatively successful. Before World War I, the view that the banks were already working in the national interest, had adequate self-regulation, and, therefore, needed no further state regulation was widely held inside and outside Germany.

Still, it is important not to exaggerate the economic power of Germany's universal banks. Many of the banks' clients were sufficiently cash rich that they were able to dictate terms to the banks. Banks often had to work through consortiums to provide enough capital to large firms, which reduced the influence of any one bank. Only 10 percent of the metropolitan and regional banks' assets were in the form of share capital; only 13 percent of their income was in the form of dividends.⁷⁹ Their dominance in the financing of business was highly concentrated in heavy industries such as mining and metal production, not in the more cash-rich sectors such as chemicals and electronics. Before 1913, they neglected completely the massive *Mittelstand*, still the backbone of the German economy. The large German banks were also counterbalanced by a powerful savings bank and cooperative sector that catered to this *Mittelstand*.

Exhibit 4: Total Assets Held by German Financial Institutions by Sector, 1860–2001

⁷⁸ Gall, 49.

⁷⁹ Gerd Hardach, "Banking in Germany, 1918-1939," in *Banking, Currency, & Finance in Europe Between the War*, ed. Charles Feinstein (Oxford: Clarendon Press, 1995) 270-271,



Source: Richard Tilly, *Short History of the German Banking System*, p. 302.

The large banks controlled just 10% of total banking assets in Germany in 1913 and just about 14-15% today. Not until the 1920s after a wave of consolidations did they begin to swallow up other private commercial banks as well merge with private banks. But most importantly a strong, socially-oriented savings bank sector, which was the largest single sector. Mortgage banks and other such specialized lending institutes were also larger in terms of banking assets. In short, then in 1913 as today, Germany remained a highly fragmented banking system built along the “three-pillar” model of private commercial, savings, and cooperative banks—a highly class-stratified banking model.

The concentration of German banking took many forms during this period, but the form of German regulation hindered, however, other forms of concentration. From 1870 through 1913, the large banks acquired 504 banking companies, 367 of those acquisitions occurring between 1901 and 1913. But the German banking system remained quite fragmented, creating at least the potential for the kinds of conflicts of interest Roe views as the primary cause for America’s dispersed shareholder structure. As early as 1880, independent banks were organized into *Interessengemeinschaften* (Communities of Interest), permitted by regulatory authorities to “coordinate business in a communal fashion” for pooling business and dividing profits. The concentration of banking gave the large German banks greater economies of scale and enormous market power with their clients, but their branch networks were nowhere near as large as those in England,

because of high registration and administrative costs for branches.⁸⁰ The *Interessengemeinschaften* and participations in local banks offset, to a large extent, the need for as large a network like their English competitors. The state itself limited the growth of large bank networks. According to Manfred Pohl, the most important factor in hindering the branch development of the large, mostly Berlin banks, was the Reichsbank's own network of offices, which was a kind of counterweight for the competitive advantages of the large Berlin banks.⁸¹

As in America, the number of local banks mushroomed. In Prussia alone, there was an enormous increase in small local savings banks (*Sparkassen*). From 1839 through 1913, their number grew from 85 to 1765. In 1913, there were 3113 *Sparkassen* with assets of 20,547 million mark.⁸² In 1913, *Sparkassen* had over double the assets of the large banks (9). Provincial banks in total (151) had roughly the same level of assets as the nine large banks, whose share of the total assets was less than 14 percent.⁸³ Some regional and local banks were even owned and run by state and local governments.

Thus, in spite of the enormous size and market power of universal banks before World War I at the commanding heights of German capitalism—Germany's three largest enterprises as measured by capital were banks, 17 of the top 25 – the banks were generally seen as positive contributors to the German economy and general fabric of German society.⁸⁴ Through most of the 20th century, whatever criticism was directed at the large banks' power was partially counteracted by a consensus that the alternative was casino *capitalisme a l'Americaine*, the rule of the stock market.

The persistence of these corporate governance forms also points to more deep-seeded attitudes, let alone that this famous “three-pillar” structure of German banking that has proved remarkably stable. Many commentators were struck after World War I by the degree to which German economic reforms seemed more designed to coordinate business and add stability during the Weimar Republic, even at the cost of economic

⁸⁰ Pohl, 200-202.

⁸¹ The Reichsbank operated 487 branches throughout Germany, which provided various banking services. Pohl, 203.

⁸² Pohl, 272.

⁸³ Pohl, 280.

⁸⁴ Richard Tilly, “An overview on the role of the large German banks up to 1914,” in *Finance and Financiers in European History 1880-1960*, ed. Youssef Cassis (New York: Cambridge University Press, 1992) 94.

efficiency.⁸⁵ The economic, social and political crises of the Weimar era, witnessed vociferous attacks on the entire banking sector and its alleged contribution to the immense difficulties of Weimar Germany. But unlike similar criticisms in the United States, these attacks, from both the left and the right, produced no significant change in the economic role played by banks; macroeconomic troubles altered the role of the banks due to hyperinflation and depression. When economic conditions worsened at the end of the 1920s, criticism of banks and their actual financial weakness led to direct government control of the banks, but *not* a reduction in their powers vis-à-vis non-financial companies. According to the banking historian, Harold James, banks were under pressure in 1927 from Haljmar Schacht, President of the Reichsbank, to reduce their holdings in companies, but these efforts came to naught. Even though the 1920s and 30s witnessed a voracious attacks on big banks, they were focused mainly on the banks flawed lending strategies, insufficient assessment of risk, and favoritism to large companies, not the centralization of power as such—except on the Marxist left.⁸⁶ There was still widespread consensus in the social and economic benefits of personalized and concentrated control in the long-term life of the enterprise.

Only the Nazi government ever posed a serious political threat to the universal banks' privileged position with clients. They nearly wiped out the important class of Jewish private banking houses. But even the Nazis, during the early years of their regime, used the banks' privileged position with clients to help “coordinate” business. Only during the late thirties did the regime take steps to limit the effective control of large shareholders and bank administrators, and then mainly to coerce companies to focus more on military priorities and removing Jewish influence.⁸⁷ Even under the Nazis, there was no attempt to remove bank representation on boards, ownership of shares, and deposit-taking activities. As Lothar Gall wrote, “[U]p to now, however, the state has never, as we have seen, intervened decisively in the universal banking system.”⁸⁸

⁸⁵ See Robert Brady, *The Rationalization Movement in German Industry* (Berkeley: University of Californian Press, 1933).

⁸⁶ Wixforth and Ziegler, 251.

⁸⁷ See Harold James, *The Deutsche Bank and the Nazi Economic War Against the Jews* (Cambridge: Cambridge University Press, 2001)

⁸⁸ Lothar Gall, “The Deutsche Bank from its Founding to the Great War,” in Gall, et al, *The Deutsche Bank, 1870-1995* (London: Weidenfeld & Nicolson, 1995) 28.

Ultimately, then German corporate governance was designed to protect individuals from themselves, from instability and from, above all, speculation, which was ill defined, but associated with short-term money making or, more generally, making money from money, as Aristotle put it, the “breeding of money.”⁸⁹ Banks offered a sort of paternalistic, guarding, protective role for investors and their clients, the industrial firms. This stabilizing, guardian role was also extended to the stock exchange.

Iic. Banks as Public Accountants: The Creation and Evolution of the Treuhand.

Not all the impetus for entrusting banks with many corporate governance functions came from German political and economic events. One of Germany’s first bad experiences with American foreign investments thrust the banking sector into providing audit and bankruptcy services, first for foreign investments and then for domestic. This reaction to American financial crises and the information needs of investors set Germany accounting on a very different path than American.

Formed in 1890 by Deutsche Bank and other German banks to help introduce American shares in Europe by overcoming regulatory impediments in Germany (minimal nominal value of shares, for example) and alleviate worries about U.S. capital market weaknesses,⁹⁰ the Treuhand originally was conceived as a kind of trust company, which would sell its own debt and invest the proceeds in American securities. Paradoxically, the Treuhand was also one of the first beneficiaries or casualties of the railroad crisis. When the Northern Pacific filed bankruptcy in 1893, the Treuhand was called in to help sort out the financial affairs of the line and salvage investors’ funds. Deutsche Bank’s effort to improve the transparency and its own control of American financial information had profound effects on the development of German accountancy. Management quickly determined that the risks of future investment in this kind of mutual fund were too high. The Treuhand’s first name reflected the original mission, Deutsche-Amerikanische Treuhand-Gesellschaft (German-American Trust Company). Based on information provided in part by Henry Villard, the German-American financier who had brought millions in German funds to the U.S., it took its original model from the London & New

⁸⁹ “Politics,” *The Basic Works of Aristotle* (New York: Random, 1941) 1141.

⁹⁰ *Wall Street Journal*, April 13, 1891, Proquest.

York Investment Corporation, which helped bring companies to capital market by guaranteeing a price for their securities on exchanges, much the same way as underwriters do today for an all-in-launch of securities. The British investment company earned healthy commissions and reimbursement for expenses, allowing for very high dividends at times.⁹¹ One of Treuhand's first projects – and controversies – also came from Villard: the purchase of \$5 million in Edison General Electric stock and bonds, funded by a Treuhand bond.⁹² The Treuhand's relationship to Deutsche Bank was obviously very close. In fact, it was at times hard to separate the two, a fact which would play an important role in the development of the German accounting profession.⁹³

But as early as 1891, the Deutsche Bank's original strategy and the relationship with Villard showed signs of strain, which in turn affected the Treuhand. Georg Siemens, the first speaker of Deutsche Bank's management board, informed Villard about rumors as to whether Deutsche Bank would even take the lead in registering Edison's shares on the German market. According to Siemens, the only obstacles to Deutsche Bank's handling the transaction were purely technical ones, with which the Treuhand was designed to deal. The Treuhand was equipped also to act as special transfer agent, that is, to take the shares, give a legal receipt to sellers, and exchange the securities in New York. Since all of this was doable and part of the original intent of the Treuhand, Siemens could only interpret any reluctance as evidence that Villard did not want to do the registration with Deutsche Bank and the Treuhand.⁹⁴

The Treuhand was integral to Deutsche Bank's strategy in the U.S. As Siemens also reminded Villard, the recent strategy of Deutsche Bank in North America was to “assist German capital to participate in American equity investment by offering a concentration point. Out of this idea arose the Treuhand.”⁹⁵ Without the capacity to sell

⁹¹ Dernburg of the Treuhand to Deutsche Bank, March 18, 1901, HADB, S-1929.

⁹² Deutsche Treuhand-Gesellschaft to Georg Siemens, January 11, 1892, HADB, S-1929.

⁹³ Dernburg to Siemens, January 29, 1892, HADB, S-1929. Bernhard Dernburg, an experienced banker who worked for BHG and Deutsche Bank, asked Siemens to whip up interest in the German public for the Edison securities and to remove objections posed by AEG. On occasion Siemens was asked to use his influence to solve problems or drum up enthusiasm for a security

⁹⁴ Siemens letter to Villard, May 22, 1891, copied to the files of Villard, Edison, and Deutsche Treuhand other correspondence in file from 1891, HADB, A-1247.

⁹⁵ Siemens letter to Villard, May 22, 1891, copied to the files of Villard, Edison, and Deutsche Treuhand other correspondence in file from 1891, HADB, A-1247. Ironically given the difficulties that occurred

securities on the German market, Deutsche Bank would be “robbed” of any chances to enter the U.S. and “expelled” from the New York capital market. Only with this capacity could Deutsche Bank hope to win the leadership in new American securities launches, like that with Northern Pacific preferred shares the year before.⁹⁶

By October 1892, the Treuhand partners considered changing the statutes and capitalization of the relatively young firm. Siemens pointed out to his colleagues that the Treuhand was not generating enough profit to justify its considerable amount of capital. He advised reducing the capital and changing some of the firm’s functions, although he did not specify what alternations should be made in how the Treuhand did business.⁹⁷ Between 1892 and 1894, the Treuhand’s stake-holders determined that it should focus on its oversight rather than market-making functions.

The main activity of the Treuhand in the 20th century, auditing, had not even been envisioned in its original by-laws. The reorganization of the Treuhand came on the heels of the Northern Pacific debacle. In 1894, nine of its total ten million Mark of paid in capital was returned to investors and the company by-laws were changed to allow for a larger geographic orientation beyond the U.S. and to issue “certificates or opinions about securities.”⁹⁸ With the crisis of German confidence in American securities, which followed the Northern Pacific and other collapses, the emphasis now became evaluation investments and the protection of German interests by helping to reorganize threatened companies with heavy German participation, a role it had already played in the 1893 Northern Pacific crisis. Although we have no detailed documentation to explain the change in business model and no details about how much the Treuhand billed for its services during the crisis, the extensive activities connected with that reorganization probably alerted the participants to the possibility of earning income from U.S. investment with far less investment and risk than running an investment fund. It became a kind of consulting spinoff of the member banks, dedicated to the control function

early on, but not atypical for Villard, his letter of congratulations to Deutsche Bank on the founding of the Treuhand also contained a bill for \$44,439 of his expenses.

⁹⁶ Siemens letter to Villard, May 22, 1891, copied to the files of Villard, Edison, and Deutsche Treuhand other correspondence in file from 1891, HADB, A-1247.

⁹⁷ Siemens to Stern, October 28, 1892, HADB, A-0401.

⁹⁸ *KPMG Deutschland vom Ende des 19. Jahrhunderts zum Beginn des 3. Jahrtausands*. Teil 1. (Berlin: KPMG Deutsche Treuhand-Gesellschaft, 2003), pp. 13-16.

associated with the banks' view of their responsibilities and regulatory expectations about their *Aufsichtsrat* duties. Many other banks followed suit. Some banks in the U.S. pursued this model of combining banking and auditing, though it was later banned.⁹⁹

In 1901, the Treuhand was reconstituted once again as the Deutsche Treuhand Gesellschaft (DTG) and focused more of its attention on auditing American companies.¹⁰⁰ But scandals in several German companies around the turn of the century led to demands for more audits of German firms and DTG stepped into this function as well as managing the “turnarounds” of troubled firms, in much the same way as the Treuhand had learned through its experience with receivers in the U.S. By 1904, the Treuhand, however, was still holding some company securities and had a breakup value of 200% of par value.¹⁰¹ In 1907, the company was preparing the financial statements for 400 German firms. Although audits were not required of large German companies until 1931, some say that DTG laid the foundations for the accounting and audit profession in Germany but also decades of internal strife in the profession. Developing a unified, powerful accounting profession in Germany was impeded by internal conflicts between the large bank sponsored audit firms, like the Treuhand, and the smaller “independent” firms, which viewed their competitors with suspicion. Many professional accountants believed that the bank-sponsored firms could never preserve their professional autonomy. The inability of these two types of firms to work together far exceeded rifts in the U.S. and U.K. professions. For decades, the audit and accounting functions remained very tied to supervisory boards – and, therefore, banks – in Germany, while Anglo-American professionals focused more on the needs of dispersed shareholders and large impersonal equity markets.¹⁰²

Changing the organization from representing the interests of large- and medium-sized banks to an audit firm more modeled on American and English examples required a

⁹⁹ Jeff Fear and Christopher Kobrak, “Accounting for Control, Diverging Paths,” *Business History Review*, Spring 2006.

¹⁰⁰ Wilkins, p. 511.

¹⁰¹ Gwinner to Eduard Beit, Lazard Speyer Ellissen, January 21, 1904, HADB, A-1140.

¹⁰² Jeff Fear and Christopher Kobrak, “Accounting for Control, Diverging Paths,” *Business History Review*, Spring 2006.

complete reorganization of the firm, putting the audit activity on a more professional, discrete basis. One success factor was changing corporate attitudes about audit.¹⁰³

During the first decade of the 20th century, the Treuhand began an extensive marketing and education campaign to get auditing more integrated into the German financial system. It produced a memo that was circulated among banks and other financial institutions in Germany, which reminded readers of how certain stock manipulations, such as those with Oberschesischen Kokswerken and Ostfriesischen Bank, had tarnished Germany's capital markets. It contrasted German practices with those in England, where audits were a sacred duty and audits performed by Chartered Accounts had a hundred year tradition and legal backing. Given German views of audits, even companies with nothing to hide were afraid to arrange for audits for fear of being stigmatized as a company that was suffering from some financial embarrassment.¹⁰⁴

Several of Germany's most prestigious firms were behind a general movement to make audits a normal business practice in Germany. The excuse that audits were more expensive in Germany did not hold water. Certainly, adding to their frequency might reduce the cost. If banks and commercial companies acted together, however, Germany could get out of the childlike state (*Kinderschuh*) of current praxis in this area. Although Anglo-Saxon auditors have for a long time warned that standard financial audits are not designed to find fraud, the memo argued that banks had a special interest in changing common practice since they suffered most from fraud and misuse of funds that could be checked with relative ease.¹⁰⁵ The memo was circulated by Deutsche Bank to other banks with a recommendation for regular audits and about the independence and standards of the Treuhand to incorporate the best practices of England and the United States for German firms.¹⁰⁶

Despite some rough years brought on by low profits and even some competition, mostly from other banks which wanted to develop the same model, the first decade of the 20th century witnessed some success with the introduction of this concept to Germany and an expansion of the Treuhand's activities. It remained to a large extent an additional

¹⁰³ Report of the Deutsche Treuhand-Gesellschaft, February 1910, HADB, S-1929.

¹⁰⁴ Exposé Deutsche Treuhand-Gesellschaft, September 22, 1905, HADB, S-1929.

¹⁰⁵ Exposé Deutsche Treuhand-Gesellschaft, September 22, 1905, HADB, S-1929.

¹⁰⁶ Deutsche Bank to Wuerttembergischen Vereinsbank, October 11, 1905, HADB, S-1929.

service added on or dominated by banks, unlike its British and U.S. audit firms.¹⁰⁷ No doubt the banks derived some benefit from supporting audit companies, but there were risks too. Deutsche Bank had to deal with irate customers who could get offended by Treuhand reports.¹⁰⁸

By 1910, the Treuhand was enjoying a great measure of success in its new role. In that year it employed 65 auditors and assistants, and it reported nearly M. 1 million in audit revenues with profits of approximately M.5 million on M. 2 million of paid in capital.¹⁰⁹ Key members of Deutsche Bank's organization served in diverse capacities with the Treuhand over many decades. After Siemens retirement and untimely death, Gwinner took over as chairman. Alfred Blinzig, who served on Deutsche Bank's managing board from 1920 through 1934 and was very involved in American business before and after World War I, served for a period on the Treuhand's *Vorstand*. Oscar Schlitter, who served on Deutsche Bank's *Vorstand* from 1912 through 1932, had his first close contact with Deutsche Bank while serving on the Treuhand's *Aufsichtsrat*.¹¹⁰

Benjamin Strong, President of Banker's Trust in 1913 and then, in 1914, first Governor of the Federal Reserve Bank of New York, found the Treuhand to be very important to German capital markets.¹¹¹ He observed in his trip reports about his June 1914 visit to Berlin that it really was unnecessary to visit the office, which was purely administrative. The real management was at the various bank branches, so intertwined were the Treuhand's activities with Deutsche Bank's. It was the oldest and most responsible trust company in Berlin, he reported, conducting business with bondholders when the "occasion arises." Whenever it got involved in a bankruptcy an ad hoc committee would be formed, coordinating the activities of bondholders, holding on to the securities, which could be sent to the U.S., if necessary, and negotiating with the

¹⁰⁷ Various documents, HADB, S-1929.

¹⁰⁸ See Deutsche Treuhand-Gesellschaft to Carl Micholowsky, Director Deutsche Bank, October 22, 1910, HADB, S-1929 and other correspondence about complaints from Deutsche Bank's Dresden branch about comments in an audit report about his local client, a now angry and offended Deutsche Bank customer.

¹⁰⁹ *Frankfurter Zeitung*, March 27, 1911, HADB, S-1929.

¹¹⁰ Report of the Deutsche Treuhand-Gesellschaft, February 1910, HADB, S-1929.

¹¹¹ Biographical Letter to George Derby from Benjamin Strong, December 9, 1924, New York Federal Reserve Archive.

government about reductions in the stamp duties, which could amount to ½ to 1% for issuing new securities.¹¹²

Despite Strong's complimentary assessment of DTG and other German accounting firms, perhaps because of their connection with banks or the many shocks to German equity markets, an important stimulus for public accounting information did not achieve the independence and recognition of their Anglo-Saxon counterparts.¹¹³ Besides, shortly after Strong's visit, German investors developed a whole series of other worries in the U.S. Clearly, with offices in Germany and many other countries, DTG continued to play an enormous role in the history of the accounting profession in Germany during much of the 20th century. In 1986, in some sense the different paths taken by American and German accountants met. DTG merged with the Big-Eight accounting firm, Peat, Marwick, Mitchell to form KPMG.¹¹⁴

Within a few decades of DTG's founding, other banks joined in Deutsche Bank's sponsoring of DTG or founded their own audit firms.¹¹⁵ Unlike their British and American counterparts, banks were instrumental in the creation of the first German auditing firms as adjuncts of control for their investments, though the precise breakdown is unknown. Because of this, an inevitable conflict of interest arose because people questioned the independence of their opinions.¹¹⁶ For a considerable period, the distinction between investment trusts, trust companies, and independent auditors remained blurred. Although audits were not required of large German companies until 1931, during the first half of the 20th century, DGG and other bank-affiliated firms played an integral role in the German financial system, a role that was often bitterly resented by independent audit firms.

Forbidden by U.S. regulation to enter the audit business, banks in the U.S. were supplanted by professional and dedicated audit firms. Whereas in Germany the audit function remained part of the supervisory board's responsibility and banks played a leading role in supplying audits, in the U.S. audit and other advisory services were

¹¹² Strong Papers, Strong's Trip to Europe, May-June 1914, FRB, 1001.1.

¹¹³ Kobrak and Fear.

¹¹⁴ KPMG, pp. 31-37.

¹¹⁵ Various letters and pamphlets, Deutsche Treuhand-Gesellschaft Dossier, 1890-1912, HADB, S-1912.

¹¹⁶ Henning, "Die externe Unternehmensprüfung," p. 21-23. Markus, *History of the German Public Accounting Profession*, p. 6-27.

increasingly out of the acceptable realm of banking services, thus contributing to focusing on financial services and creating a whole host of new service organizations.¹¹⁷

II.d. The Stock Exchange, the Stamp Act, and Banking Stewardship

Much of Germany's capital-market legislation before World War I gave large banks a privileged role in equity transactions. The key 1896 Stock Exchange Act tightened regulations and strengthened the role of banks as key intermediaries on the stock market in the interest of corporate solidity, dampening unhealthy speculation, and mitigating volatility.¹¹⁸ One measure what a decisive turning point this Act marks is that not until 1989 were futures and options permitted on the exchange; more complicated derivatives could not be developed and traded until the First Financial Market Promotion Act of 1990, which also eliminated myriad taxes on securities trading.

Futures and options were the first derivatives and came in for heavy criticism particularly in the commodity grain trade in *both* the U.S. and Germany. Brokers appeared to gamble with the most necessary staple of ordinary life and with the livelihoods of ordinary farmers. In both the U.S. and Germany, the association of the stock market with a casino, a "fictitious," "unnatural", "phantom," "immoral," "unproductive," game (*Börsenspiel*) was more than common. One German contemporary, Joseph Neuwirth, called the stock exchange a "pure hellish gambling den" (*pure Spielhölle*). When Lasker spoke of the stock market as an "academy for circumventing the law," he met roaring, approving laughter by his fellow Parliamentarians. Even prior to the 1873 crash, the exchange seemed to many nothing more than a rigged casino offering limitless reward with little risk. The free, uncontrolled

¹¹⁷ See Reiner Quick, "The Formation and Early Development of German Audit Firms," *Accounting, Business & Financial History*, Vol. 15, No. 3, 317-343, for an excellent discussion of the early history of German audit. For an analysis of how American regulations helped create consulting firms see Christopher McKenna, *The World's Newest Profession: Management Consulting in the Twentieth Century* (Cambridge: Cambridge University Press, 2006)

¹¹⁸ Key texts on this Act are Steffen Eube, *Der Aktienmarkt in Deutschland* (Frankfurt/Main: Fritz Knapp Verlag, 1998), on the important 1896 Exchange Act, see pp. 43-49. Johann Christian Meier, *Die Entstehung des Börsengesetzes vom 22. Juni 1896* (St. Katharinen: Scripta Mercaturae Verlag, 1992). Max Weber, *Börsenwesen, Schriften und Reden 1893-1898*, ed. Knut Borchardt (Tübingen, 1999). Also Henry Crosby Emery, "The Results of the German Exchange Act of 1896," *Political Science Quarterly* 13 (1898): 286-320; Caroline Fohlin, "Regulation, Taxation and the Development of the German Universal Banking System, 1884-1913," *European Review of Economic History* 6 (2002): 221-54.

movements in prices seemed to be incontrovertible evidence that there was nothing objective (*sachlich*) in their pricing. Those movements offered too many opportunities for speculation. By contrast, long-term banking relations built on equity, credit transactions, and supervisory board relations, however, helped transform banks from mere investors (speculators), into partners with industrial enterprises. Speculative fever was fueled especially by seemingly exotic transactions like uncovered forward sales or futures (*Termingeschäft, Differenzgeschäft*, “differences,” “setting-off”), with which “one could sell, what one doesn’t have, and one can buy what one never wants to take possession of.” Futures, the first derivatives, came in for particular criticism as they arbitrated time contracts rather than the actual physical delivery of commodities—the ultimate airy speculation let loose like a balloon from the real world. But it affected people’s lives, particularly that of powerful agrarian interests in both the U.S. and Germany, a sector already hit hard by declining prices and globalization.¹¹⁹

What is remarkable about the discussions regarding the stock exchange and speculation is how parallel they were, but the results diverged dramatically because of differing attitudes toward banks (more accurately, relationship banking) and the political

¹¹⁹ Glagau, *Börsen- und Gründungswindel*, Bd. 1, p. 4 quoted in Meier, *Entstehung des Börsengesetzes*, p. 9; Neuwirth quote also from Meier, p. 9; for a discussion about futures, see pp. 27-43. Also see Knut Borchardt (Hg.), *Max Weber Börsenwesen: Schriften und Reden 1893-1898* (Bd. 1-2) (Tübingen: J.C.B. Mohr (Paul Siebeck), 1999); see Bd. 1, pp. 26-31 for the public perceptions of stock markets and how it influenced legal prescriptions. American popular opinions of the stock market were hardly more positive at the time and futures on grain were just as controversial. See Jonathan Ira Levy, “Contemplating Delivery: Futures Trading and the problem of Commodity Exchange in the United States 1875-1905,” *American Historical Review*, Vol. 111, No. 2 (April 2006), pp. 307-335. See David A. Zimmerman, *Panic: Markets, Crises, & Crowds in American Fiction* (Chapel Hill: University of North Carolina Press, 2006), esp. pp. 81-122 on Thomas Lawson. Lawson was a former Wall Street insider, who published *Frenzied Finance: The Crime of the Amalgamated* (New York: Ridgway, 1905). Julia Ott marks the war bonds drive during WWI as the crucial turning point in American attitudes toward the stock market, see Julia Ott, “The ‘Free and Open’ ‘People’s Market’: Public Relations at the New York Stock Exchange 1913-1929,” *Business and Economic History On-Line*, Vol. 2 (2004), 1-43, available at www.thebhc.org/publications/BEHonline/2004/Ott.pdf. It is based on her dissertation, Julia Ott, *When Wall Street met Main Street: The Quest for an Investors’ Democracy and the Emergence of the American Retail Investor 1900-1930* (Dissertation: Yale University, 2006). Especially after the depression and the Second World War, the New York Stock Exchange had major legitimation issues, see Janice Traflet, “‘Own Your Share of American Business’: Public Relations at the NYSE during the Cold War,” *Business and Economic History On-Line*, Vol. 1 (2003), pp. 1-21, available at www.thebhc.org/publications/BEHonline/2003/Traflet.pdf. *Ibid.*, “Spreading the Ideal of Mass Shareownership: Public Relations and the NYSE,” *Essays in Economic and Business History* (2004), pp. 257-273. *Ibid.*, *Spinning the NYSE: Power and Public Relations at the Big Board* (Dissertation: Columbia University, 2004). As we noted in our article “Diverging Paths,” the collapse in value of German war bonds in the great inflation and the continuing weakness of equity markets in the Weimar Republic had the opposite effect on German investors.

weight of agrarian power. One can see the remarkable parallels with the discussions about futures trading. In both countries, rising pressure to bank futures simmered in the 1880s, but burst forth in the early 1890s. In 1894, the U.S. Congress held hearings on futures trading, which was referenced in the 1896 German parliamentary debates and subsequent 1896 legislation. In 1891, the populist National Farmers' Alliance put the first organized proposal to prohibit futures. As a result of sinking prices in 1892, German agrarians formed the powerful Association of Agriculturalists (*Bund der Landwirte*), one of the most powerful lobbies of pre-1913 Germany. Their program called for "sharper state supervision of commodity exchanges to prevent an arbitrary, damaging price formations harming agriculturalists and consumers in an equal manner." Once Catholic party member declared that futures trading should be "bled to death" through high taxes; another wanted generally higher taxes on stock exchange trading: "the higher, the better."¹²⁰

Aside from the one goal of dampening (if not destroying) futures trading, the creation of the Stamp Tax (tax on security transactions) is the best example demonstrating the political willingness to stress universal banking as an acceptable social control on investing. Under the original Stock Exchange Taxation Act of 1881, all stock market transactions entailed a tax for the first time, initial issues as well as seasoned offerings and subsequent trading. Only the securities of central and state governments, and the transactions of charitable and public organizations, such as professional groups, were exempted. A later 1884 amendment, prompted by conservative parties, substituted a fixed tax per transaction for one based on a percentage of the amounts traded.¹²¹ The act was modified many times.¹²² The amount of the tax was relatively small, initially amount to 1/10th of a percent per 1000 mark of market value, or 10 pfennig for a one-thousand mark transaction, but posed many potential problems for financial institutions

¹²⁰ Compare, Levy, "Contemplating Delivery," pp. 322-327; Borchardt, "Einleitung," *Max Weber Börsenwesen*, pp. 66-74; quote from p. 70. Also Meier, *Entstehung des Börsengesetzes*, p. 238.

¹²¹ Gall, 82 -84.

¹²² Karl Bott, ed. *Handwörterbuch des Kaufmanns: Lexikon für Handel und Industrie* (Hamburg: Hanseatische Verlagsanstalt, 1927) 385-386.

and their customers.¹²³ Both parties to a transaction were liable for the tax. Merely keeping track of what was owed would add a lot of new transaction costs for brokers.

By 1894, the amounts for some transactions had trebled, causing great concern for traders, brokers, and bankers. Although his bank would ultimately profit enormously from these pre-World War I laws and regulations governing securities transfers, Georg Siemens, chairman of Deutsche Bank's *Vorstand* and a member of the Reichstag, argued that stamp tax was deliberately aimed at reducing capital movement and risked driving business outside of Germany. He also addressed what he considered the broader intentions of those who designed the law, namely to exercise greater control over economic activity, which he believed to be a dangerous tendency. According to Siemens, business people were the ones who lived and died by knowing their markets and matching needs with resources, not bureaucrats. Like Gerson von Bleichröder, one of Germany's leading private bankers, he feared that the law would entail more regulatory intrusion into bank affairs.¹²⁴ Implementing the tax law would require the government to investigate, or at least, be capable of investigating all transactions. A lot of information about transactions had to be recorded and open to minor bureaucrats, who might use that information in ways that might be harmful for the banks' business interests. "Precisely with this control issue, the creators of the law are hitting business people in their most vulnerable place."¹²⁵

Like several other pieces of legislation proposed around the same time, such as a direct tax on passive income, the stamp tax seemed directed at those who made their living with passive income and to thwart stock-market speculation by adding to the transaction costs of getting in and out of stocks. For the general public, the stock market

¹²³ Riesser, *Die deutschen Großbanken und ihre Konzentration*, p. 502. According to Fritz Neumark in "Die Finanzpolitik in der Zeit von dem I. Weltkrieg," in *Währung und Wirtschaft in Deutschland 1876-1975*, ed. Deutsche Bundesbank (Frankfurt am Main: Fritz Knapp GmbH, 1976), p. 90, the amounts collected from the tax in 1913 made up a significant portion of the Reich's income, but he does not give basis of calculation in that year. According to the *Statistisches Jahrbuch für das Deutsche Reich*, Kaiserlichen Statistischen Amte, ed.(Berlin: Puttkammer & Mühlbrecht, 1913) 334, the tax amounted to nearly 7% of all Reich *tax* collections. Collections from the tax were up by 50% from the amount collected in 1909. It is important to remember that Germany had no income taxes and that total "federal" and state expenditures were only 14% of Germany's Mark 40.0 billion in GDP.

¹²⁴ Stern, *Gold and Iron*, pp. 220-221.

¹²⁵ Georg Siemens speech to the Reichstag, January 21, 1885, *Stenographische Berichte Deutsches Reichstags*, Berlin, 1885.

provided no more social value than a casino. One German minister called the stock exchange “ a poison tree ... casting a baleful shadow over the nation.”¹²⁶ As one historian wrote, “Dealing on the stock exchange was regarded as peculiarly unproductive sin as it brought no visible results, created no values and basically served no purpose but that of speculation.”¹²⁷ The framers of the bill hoped that it would encourage stability (few trades and less panic) and long-term capital investment, while hurting mostly Jewish stock brokers, who were in the eyes of many the true culprits behind the speculation and panic.

Despite all the fears of the banking community about lost business and regulation, a new stamp tax law was passed in 1885 and went into effect in 1886. Though some thought the act would help smaller banks, for numerous reasons, it proved to be a boon for the large ones, which effectively replaced the stock market for individual transactions, leaving the stock market itself principally for settlements among banks. It is unclear whether the intent of the law was to make the large banks intermediary institutions that would somehow protect individuals from that den of inequity, the stock market. Some believed that this was the intention of the framers. As early as the spring of 1884, the *Frankfurter Zeitung* wrote that the new law would lead “to a monopoly of bank business in a few powerful hands.”¹²⁸ Others believed that the economic ignorance of legislators was so great that there was no telling what the laws that they draft would produce.¹²⁹

The stamp tax was passed for several reasons, not the least of which was to raise central government revenues, which, because of Germany’s constitution was a regular source of conflict, and to reduce stock market speculation. Some supporters also hoped that it would strengthen the position of small- and mid-sized banks. That it led to the exact opposite effect for those banks – that is, to strengthening the large banks – requires understanding the history of the law and the structure of the banking sector.

There were three types of banks in Germany: large, universal banks, like Deutsche Bank; small private banks, like the Berliner Handels-Gesellschaft, and small

¹²⁶ Quoted in Gall, 82.

¹²⁷ Gall, 82.

¹²⁸ Quoted in Riesser, 502. May 26, 1884 issue, nr. 147.

¹²⁹ Riesser Speech, *Verhandlungen des ersten Allgemeinen Deutschen Bankiertages, September 19 und 20, 1902, Stenographischen Niederschrift* (Berlin: Bankiergewerbes, 1902) 2.

regional banks. Of the three, only the universal banks had large a client base and a seat on the exchange. Within a few decades, the law had weakened the position of even the private bankers, who sat on exchanges and executed trades for clients, forcing them into strategic alliances with the universal banks.¹³⁰ Customers had an incentive to use the large banks or their branches rather than their local banks, because the large banks had direct access to the stock market.¹³¹ The more intermediary sales there were, the greater the overall costs. In addition to lower transaction costs, the large banks could offer other services such as dividend collection that were harder for smaller private or regional banks to perform.

Moreover, the authorities' interpretation of the legislation added to the competitive advantage of the large banks vis-à-vis smaller banks. These included the large banks ability to make sales internally (*Kompensationsgeschäfte*), which will be discussed in more detail shortly, and the higher capital requirements of the new stock exchange law, which effectively excluded the small and medium-sized banks from daily speculation and arbitrage transactions, because of the smaller banks higher transaction costs.¹³²

Whereas banks may have been able to avoid some of the burden of the tax with "private" transactions, the threat of the new law was sufficiently important and unwelcome to the banks that in 1883 the twelve major large and private banks founded the *Stempelvereinigung* (Vereinigung Berliner Banken und Bankiers, which later represented banks in other regulatory matters), ostensibly to clarifying the regulations regarding the application of the stamp tax, but, in reality, the organization actually lobbied for reduction of the tax or better yet complete exemption from it.

The association was eventually able to win some exceptions to the law, which also played into the strengths of the larger banks. As discussed, one of the many advantages of the larger Berlin banks, which undermined the competitive position of smaller local banks and private banks, was their large client base. Not only did this client base give access to funds for launching new equity and debt securities, their

¹³⁰ Paul Wallich, *Die Konzentration im Deutschen Bankwesen* (Stuttgart: J.G. Cotta'sche, 1905) 83-92.

¹³¹ Riesser, *Die deutschen Großbanken und ihre Konzentration* (Jena: Gustav Fischer, 1912) 502-503.

¹³² Riesser, 504-505.

transaction costs were lower. All the big banks had to do was arrange for sales among their clients, thereby avoiding the stock market, which lowered overall transaction costs. Somewhat unintentionally, increases in the Stamp Tax internalized transactions inside banks, effectively turning them into a sort of silent stock exchange. During the 1890s, the stamp tax was nearly doubled and a new calculation method developed that increased the cost and added further limitations on what would qualify as a tax free transactions on the exchange, further reinforcing the position of the large banks. The price was for this unintended competitive benefit was greater control of forward sales (*Terminhandel*) and greater rights for shareholders to claim damages for losses, all of which were intended in the 1896 Stock Exchange Law (*Börsengesetz*) to reduce speculative trades.¹³³

The Stock Market Law of 1896, also a product of anti-capitalist resentment, agricultural concern over indebtedness, and general fears about financial capitalism. It also witnessed some debate that included comments about leftist conspiracies with international capitalism that foreshadowed Nazi attacks on capitalism. The law tried to impede speculative purchases of securities, by taxing speculative transactions and punishing banks that engaged in them. Although the new Stock Market Law, which came into effect (January 1, 1897), was the culmination of a long debate about speculative capitalism, it left many questions about security transactions unanswered. Chief among these were the rules that would be applied to transactions of shares of stock held by banks on behalf of their clients. Using a loophole in the Stock Market Law of 1896, banks were able to convince regulators that securities traded within the bank required no stamp duty. The original drafts of the law had specifically exempted shares deposited with banks from the rules pertaining to securities transactions. The final draft made no mention of them. Bankers argued successfully that with regulators the law's silence on the matter, in effect, meant that they were exempted. All this ostensibly required further clarification, but for decades there was no legislative action, leaving the banks and bank regulators a great deal of room for maneuver. Some regulators believed that how these deposits should be regulated should be left to the banks and to "public opinion." As monies deposited with the banks were necessary for the welfare of markets,

¹³³ Manfred Pohl, *Konzentration im deutschen Bankwesen 1848-1980* (Frankfurt am Main: Fritz Knapp Verlag, 1982) 178-180.

companies as well as landed interests, regulators were prone to leave the legal loophole, as long as speculation was controlled and economic crises could be avoided. The banks were entrusted to ensure that the deposits were “properly employed.” In order to achieve this, banks and bankers in many regions established rules regarding different types of deposits, segregating those deposits that could be invested in risky securities and those that could not.¹³⁴ Banks were encouraged to make stable investments, because the distinction between speculative and non-speculative was hard to make and because customers could sue them if any of the investments recommended by the bank turned sour (*schief ging*).¹³⁵ One important contemporary American observer whose expertise informed American reforms, Henry Crosby Emery, noted how much this Act drove exchanges into the arms of banks.¹³⁶

While psychological and attitudinal preferences for banks rather than stock markets propelled political reforms—often against the wishes of bankers, politics and power explain the prohibition of futures trading. Max Weber, chair of the commission, tried to justify futures, but was overruled. Like Weber, who argued that such trading was desirable in the interest of national strategic interests, pro-futures Americans argued such a ban would only European exchanges. The powerful Association of Agriculturalists tipped the balance, which then saw the National Liberal party change its tune as they catered to their upset voters. Unlike the U.S. whose populist protest came from a vast mass of small farmers, the populist protest in Germany had the backing of powerful aristocratic elite (*Junkers*) ensconced in the heart of government. The act was passed 200 to 39. The only parties to vote against it was the Independent People’s Party (*Freisinnigen Volkspartei*) and, ironically, the Social Democrats. The futures debate also took a decidedly contentious turn in the U.S., which landed the issue at the pro-business Supreme Court, which ruled in favor of futures as a form of hedges and insurance.¹³⁷

¹³⁴ Johann Christian Meier, *Die Entstehung des Börsengesetzes vom 22. Juni 1896* (St. Katharinen: Scripta Mercaturae Verlag, 1992) 322-325.

¹³⁵ James, *Verbandspolitik*, 9-10.

¹³⁶ Emery, “Results of the German Exchange Act of 1896.”

¹³⁷ Borhardt, “Einleitung,” *Max Weber Börsenwesen*, pp. 77-81. Levy, “Contemplating Delivery,” pp. 332-335.

By 1908, the large banks had achieved two things: their dominant position in German banking and elimination of some of the most heinous aspects of the 1896 law.¹³⁸

With Germans slower to develop a faith in equity investment, German banks gave the German economy a way of funneling cash into risky investments, in a way that was quasi-equity. That is, bank deposits promised a “regular return,” like bonds. These funds were invested into firms in the form of equity and debt, which ironically gave German companies more access to equity investment than in England because of the intermediary role played by the banks.¹³⁹ The combination of stock market reforms of the 1880s and 1890s and the banks’ powerful role in the management of companies seemed to reassure investors that adequate information would be provided and reasonable directors would be appointed. Confidence was restored to a degree that individuals also bought shares, but generally through the bank.¹⁴⁰

The universal banks fulfilled, perhaps not perfectly, but reasonable well several economic and particularly German psychological needs. In particular, their personal control of companies restored Germans’ faith in equity investment. In spite of these considerable suspicions, one can hardly the pre-1914 German stock exchange(s) failures. The Berlin Stock Exchange became one of the most influential exchanges in the world: “In New York, it was asked: “How was Berlin doing?”¹⁴¹

Exhibit 5: Stock Market Capitalization Relative to GDP (in %)

	1913	1929	1938	1960	1980	1999
Germany	44	35	18	35	9	67
United States	39	75	56	61	46	152
United Kingdom	109	138	114	106	38	225
Canada	74	-	100	159	46	122
France	78	-	19	28	9	117
Italy	17	23	26	42	7	68
Japan	49	120	181	36	33	95
Sweden	47	41	30	24	11	177
Switzerland	58	-	-	-	44	323

Source: Adapted from Rajan and Zingales, “Great Reversals,” Table 3.

¹³⁸ Pohl, 180-182.

¹³⁹ Tilly, 103.

¹⁴⁰ Tilly, 104.

¹⁴¹ Christoph Buchheim, “Deutsche Finanzmetropole von internationalem Rang (1870-1914),” *Geschichte des Finanzplatzes Berlin*, (Hg.) Instituts für bankhistorische Forschung e.V. von Hans Pohl (Frankfurt/Main: Fritz Knapp Verlag, 2002), pp. 103-156; quote from p. 122.

German firms raised a considerable amount through equity, but used the equity to take partial stakes in other firms and fund internal investment, while the U.S. and UK firms used the raised capital to fund growth through full acquisition, which increasingly led to a greater separation of ownership from control and larger business concentrations.¹⁴² Exhibit 5 also demonstrates that the world of equity markets changed dramatically since 1980, but that we cannot generalize historically about attitudes held since 1980.

Nevertheless, through their holding of shares for clients, which developed out of the Stamp Act and the Stock Exchange Law of 1896, coupled with the shareholder habit of delegating voting rights (*Depotstimmrecht*) to the banks, banks had a large voice in the running of most German public companies. In short, most of the major components of Germany's corporate governance system – concentrating ownership (or at least voting rights), bank financing, separation of boards, and stakeholder vs. shareholder capitalism – were established well ahead of the social democracy, which Roe uses to explain the configuration of the German system. As one leading historian put it:

There can be no dispute, however, that the period after 1896 saw the emergence –though their origins lay earlier – of economic structures which, despite all the political upheavals that followed, have in many respects remained intact up to the present day.¹⁴³

One can see this remarkable continuity in the fact that options and futures were again first permitted only in 1989/1990. This attempt to maintain insider governance must be seen in contrast to the consistent efforts later in the United States to reduce bank involvement in corporate governance, relying rather on impersonal market forces informed by transparent disclosures, culminating in the securities and banking laws of the 1930s. Exhibit 5 also demonstrates how much World War I and the subsequent hyperinflation constitute a major turning point in German economic history—before the shock of the Great Depression and the Third Reich.

¹⁴² Frank/Mayer, *Origins of the German Corporation*.

¹⁴³ Wolfgang Mommsen, *Imperial Germany, 1867-1918* (London: Arnold, 1995) 109.

III. Building Solidity: German Financial Reporting before 1914

Designing effective financial reports to assess the performance of an enterprise and its management as well as to attract potential investors is a crucial aspect of corporate governance and investor protection. In this section, we discuss the official regulatory requirements and principles underlying the actual accounting practices used by German businesses. A number of crucial decisions made prior to 1914 as well as the general attitude toward mitigating market or corporate volatility shaped German accounting practices. The primary underlying idea propelling German financial reporting was not the protection of outside investors, but to build the solidity of the firm as a reputable, ongoing concern. The 1873 founder shenanigans profoundly influenced German financial reporting. This stress on solidity tapped into widely held *bürgerlich* attitudes and values about reputation, respectability, responsibility, and solidity, creditor protection (banks) rather than investor protection, as well as the desire for broader social stability.

A recent study comparing British and German investor protections before 1914 found that German corporate governance also “provided more extensive corporate governance than existed in virtually any other country at the time.”¹⁴⁴ Before 1914 many foreigners also found American regulation and its public accounting practices haphazard compared to the methods used in Germany. In the United States, most of the progress in financial reporting occurred in large “public service” industries. The overwhelming social importance of private railroads and utilities and the controversies that arose over their rates forced public regulators to deal with many thorny issues in accounting; they pioneered the development of arguably modern, standardized public financial statements. For most U.S. businesses, however, disclosure practices remained highly uneven. Publishing annual financial statements was largely voluntary; not until World War I did major businesses regularly publish their balance sheets—excepting those of public service firms. Modern standardized principles of accounting were not enshrined in law until the early 1930s. By contrast, Germany early on developed minimal legal standards for financial statements—advanced for the time, but did not further develop them further until the 1930s—and then under the star of the swastika. German business, however,

¹⁴⁴ Franks, Mayer, and Wagner, *Origins of the German Corporation*, p. 27.

developed a fairly sophisticated, but largely unregulated set of internal accounting rules, but these were based on significantly different principles that have influenced German accounting practices (*Handelsgesetzbuch, HGB*) until the present. **Appendix 1** outlines the major legal steps in Germany regarding “publicity” until the 1960s when European codification began.¹⁴⁵

The first codification occurred in the Prussian General Code (*Allgemeine Landrecht*) of 1794, which merely required firms to give notice about its directors, any changes in senior management or in the purpose of the business, the location of its headquarters, key correspondents, as well as who had power of attorney. The same code also made “orderly kept” (*ordnungsmässig geführte*) commercial accounting books the weight of law and evidential proof in court cases. It did not delineate any sort of stipulations about what constituted “orderly” accounting standards.¹⁴⁶

Germany’s first national commercial code (*Allgemeine Deutsches Handelsgesetzbuches*) of 1861 set the tone for much to come. They were clear that courts should administer the commercial register as a form of private law, rather than public administration, or later, the legislature. For nearly a century, courts would rule about accounting norms, rather than the accounting profession itself. (Not until discussions about the 1965 joint-stock company law that was intended to improve capital market reporting and strengthen small shareholder rights were economists invited to comment.) German accounting principles and practices are still regarded as legal rules (*Rechtsnormen*) rather than just professional norms (*Fachnormen*); lawyers and courts played a prominent role in establishing standards.¹⁴⁷ The 1861 code introduced various articles for properly registering the firm in the new commercial register and endowed certain (internal) record-keeping ledgers as standards of evidence in court. Executive board members had to prepare annual balances for *shareholders* or immediate business partners—not for potentially interested third parties—and the company had to file the

¹⁴⁵ Hawkins, “Development of Modern Financial Reporting Practices.” Schmalz, *Bilanzanalyse*.

¹⁴⁶ Except where otherwise noted, the following discussion is based on Merkt, *Unternehmenspublizität*, pp. 39-83; quotes from these pages: “keineswegs lediglich die Verhältnisse und die Interessen der Aktionäre im Auge, sie haben vielleicht in einem weitergehenden Masse die Interessen des Publikums, der Gläubiger, der dritten Personen, die mit der Gesellschaft in Verbindung treten, im Auge.”

¹⁴⁷ Merkt, *Unternehmenspublizität*, pp. 94-96, 99. Leuz und Wüstermann, “Role of Accounting,” pp. 456-457.

minutes of its general assembly meeting at the register court. Minimum stipulations for constructing balance sheets were introduced, but notification regarding the founding of the company, notification regarding executives with power of attorney, and any change regarding the purpose of the company were the main purposes.

Much of the initial controversy involved how much information should be available to outsiders. They decided, for instance, not to publish opening information regarding the assets of the firm because they would “hardly correspond to the truth,” or change within a few months and be “worthless,” or “hinder a respectable person who began his business with modest means.” German owner-entrepreneurs were also notoriously secretive. Finally, this 1861 codified the still used legal definition of a firm or corporation as a private merchant, rather than an enterprise or a general person. All in all, the 1861 code acted as a sort of seal of approval for founding or changing the statutes of a firm, but did not mandate annual published financial statements or expand the role of the register in terms of publicity vis-à-vis outsiders.¹⁴⁸

As a result of continuing dissatisfaction with the concession system after government corruption (arguably encouraged by the need for government approval), scandals, and surprise bankruptcies, the 1870 Joint-Stock Company Law moved to the normative system of incorporation. In general, it substituted ostensible state oversight with that of transparency to the public to build trust in these newfangled forms of enterprise. For instance, prior to 1870, many investors and legislators complained that some companies had managed to go into bankruptcy without ever publishing a balance sheet. A general desire to hide results from competitors also discouraged public financial reporting. The 1870 law changed all that.

Parliamentarians, including Lasker, published the dominant opinion that public financial reporting “by no means merely had the relationship and interests of the

¹⁴⁸ This would have fateful implications for Konzern building in the 1920s as well as for the utter lack of consolidated balance regulations until the late 1960s. For implications in the 1920s, see Fear, *Organizing Control*, pp. xx-xx. Thomas Raiser, “The Theory of Enterprise Law in the Federal Republic of Germany,” *The American Journal of Comparative Law*, Vol. 3 (1988), pp. 111-129. Norbert Horn, Hein Kötz, and Hans G. Leser, *German Private and Commercial Law: An Introduction* (Oxford: Clarendon University Press, 1982), esp. pp. 239-281. Franz Bauer, *Das Organschaftsverhältnis im Steuerrecht als Problem der betriebswirtschaftlichen Steuerlehre*, (Hg.) F. Schmidt, II Serie, Heft 46 (Berlin, 1930). Heinrich Friedländer, *Konzernrecht: Das Recht der Betriebs- und Unternehmens-Zusammenfassungen* (Mannheim/Berlin/Leipzig: J. Bensheimer, 1927).

shareholders in view, it has perhaps to a greater degree also in view the interests of the public, and creditors, and other third parties, who move into a connection with the enterprise.” The 1870 debate about free incorporation and the extent of public financial reporting put on the table an ongoing debate that flared up once again in the 1950s and 1960s about just who the interested public was: immediate shareholders and business partners (creditors) or society as a whole? In the debate surrounding the 1870 joint-stock law, parliamentarians implicitly assumed creditors or immediate business partners as the interested public. Not surprisingly, they also passed an extremely creditor-friendly bankruptcy law in 1877 that was not significantly revised until the 1990s. This, too, tended to privilege banks as they were the main creditors.

German financial statements (and American ones at this time too) were implicitly designed to protect creditors with most of the stress on the balance sheet as an expression of a firm’s solvency and creditworthiness. However, through subsequent developments and Imperial Court rulings in 1905, 1908, and 1915 (**Appendix 1**), Germans made it clear that society as whole was the general “public” to be protected against “dishonest dealings.” During and after the war, however, the regulation of all joint-stock companies increasingly came under a common “public interest” viewpoint, rather than merely an issue of private shareholders. In the U.S., such a “public interest” viewpoint only applied to private firms supplying key infrastructural goods: railroads, gas, water, electricity. Not surprisingly, in his critique of the 1870 law, Adolph Wagner of the *Verein für Socialpolitik*, highlighted transport and local “public needs” industries (*locale wirtschaftliche Gemeinschaftsbedürfnisse*) as needing special supervision, if not nationalization.¹⁴⁹ By World War I, Walter Rathenau, the head of AEG, head of the armaments ministry, and later Foreign Minister, popularized the notion of the “enterprise in itself” as a balance of social and public interests. The national emergency of World War I and postwar crises prioritized the national interest over private interests. A general stakeholder view of the firm has a long history in Germany well before being cemented together with codetermination.¹⁵⁰

¹⁴⁹ Schubert, “Die Entstehung des Aktiengesetzes von 1884,” p. 5.

¹⁵⁰ Walther Rathenau, *Vom Aktienwesen: Eine geschäftliche Betrachtung* (Berlin: G. Fischer, 1922). Walther Rathenau, *Wirtschaft ohne Unternehmer* (Heilbronn: H. Bezner, 1919).

Still, the 1870 joint-stock law represented a major step toward greater investor protection through publicity. According to the historian of financial reporting, Hanno Merkt: “at the same time, [it] implicitly established the connection between the capital market and financial reporting” for actual and potential investors. Joint-stock companies were freed from the need of concessions. They were required to have a supervisory and executive board, though it did not specify the exact relations between the two boards, which was subsequently addressed in the 1884 reform. Shareholders gained right to sue executive or supervisory board members. It set minimum share prices at 150 Marks for registered shares and 300 Marks for bearer shares. Quite advanced for the time, it made mandatory publication of the joint-stock companies’ balance sheets (not profit-loss statements) in key business newspapers. It also introduced basic principles of accounting that are still standard such as the conservative valuation of inventories and purchase costs (*Niederstwertprinzip, Anschaffungskosten*) and realization principles (*Realisationsprinzip*). Not until 1937 did German company law stipulate minimum standards for the profit-loss statement, which meant gross revenue and operating expenses rarely appeared, making it nearly impossible to judge the annual performance of the firm with clarity. Most subsequent reform attention focused on the balance sheet. The 1870 law mandated conservative valuations in order to protect creditors from asset overvaluations and excessive profit-sharing. The accounting tension between protecting creditors and attracting new investors rightly begins here. Finally, inaccurate financial statements were made punishable by law. Whatever bias toward creditors—not unusual for the time, the 1870 law introduced recognizably modern investor protections.

As discussed above, the 1870 law proved hopelessly inadequate to cope with all the scandals. Most of the reforms addressed the problem of foundings and increased shareholder protections. It tried to dampen get-rich-quick speculations through unserious company foundings and better valuations of company assets. The 1884 joint-stock company law was not a discrediting of liberal incorporation laws, but an increase in supervision over it. Above all, it required mandatory auditing before founding a joint-stock company—although, crucially, did not require annual mandatory audits until the early 1930s. Not surprisingly given the *Gründerkrise*, founders had to be named and contractually bound to the company in a more detailed manner, especially regarding the

purpose and form of the firm, and before outside investors would be able to invest in it. The 1884 law extended disclosure requirements to the profit-loss statements for joint-stock companies as well as companies limited by shares with silent partners; mandatory filings in Berlin newspapers for a company's prospectus and financial statements were also stipulated. Ironically, the most socially conservative critic of corporate governance, Adolf Wagner, proposed the most modern disclosure requirements. Wagner wanted quarterly reports for all banks, venture capital banks (*Gründungsbanken*), and insurance companies. All joint stock companies should be required to "draw up and publish balance sheets and profit and lost accounts according to exact and officially sanctioned schemes."¹⁵¹ Because of complications, cost, secrecy, and absolutely no consensus regarding such schemes, this proposal was not introduced. Regarding annual financial statements, the law issued further specific guidelines regarding depreciation, prudence or cautious valuations, as well as a creating a mandatory legal reserve for emergencies.

Above all, the 1884 corporate governance law introduced principles focused on preserving the financial substance of the firm. Insofar as there was a philosophy about what to present, German financial statements implicitly focused more on the interests of creditors as opposed to shareholders, the balance sheet rather than the profit-loss statement, and gave wide leeway for entrepreneurs to create hidden and open reserves to smooth earnings, even out dividend payments, and to create a sort of financial ballast for the company ship during rough seas. At the time, this was also true in most countries, including the United States. Before World War I, U.S. accounting principles also placed greater emphasis on the balance sheet (primarily conservative asset valuation for creditors, proprietary theory) and held that income stated was what should be distributed to shareholders. These principles then contributed to sketchy income statements with overly conservative charges, making the determination of returns actually made on the value of assets nearly impossible. Yet by World War I, American accounting practitioners and theorists were placing more emphasis on clearly stating gross profit and operating income, which in practice and theory was almost unheard of in German financial reporting. In the U.S., these principles began to change even more rapidly in the 1920s with even greater emphasis on the income statement, but asset valuation

¹⁵¹ Schubert, "Die Entstehung des Aktiengesetzes von 1884," p. 6.

principles still formed the basis for German accounting well into the twentieth century.¹⁵² (more on U.S. developments below).

The seminal work of the lawyer and accounting expert, Herman Veit Simon, best expressed the foundational principles of German accounting. Simon wrote the standard work on the evaluation of company financial statements just two years after the promulgation of the 1884 joint-stock company law.¹⁵³ He interpreted year-end financial statements largely in legalistic terms, that is, that they were meaningful statements of the value of corporate assets in that year, rather than a statement of what those assets could earn (in the future). The 20th century leading German accounting theorist, Eugen Schmalenbach, eventually termed this a static analysis of an enterprise, whereby the asset/liability balance sheet had priority over the profit/loss statement.

Simon's foundational work reinforced basic accounting assumptions. Two closely related guidelines drove Simon's analysis: maintenance of the enterprise as an ongoing concern (*Substanzerhaltung*), which was already explicitly incorporated into the 1884 joint-stock law, and the appropriate determination of dividends to shareholders. Shareholders should not take out excess dividends that might ruin the health of the firm. Thus, a combination of the 1870s crisis, a near universal norm that viewed the firm still in proprietary terms, and Simon's authority backed by the legal system, in effect, institutionalized a particular way of viewing corporate financial statements, which

¹⁵² See Previts and Merino, *History of Accountancy in the United States*, pp. 208-223 for American views.

¹⁵³ Herman Veit Simon, *Die Bilanzen der Aktiengesellschaften und der Kommanditgesellschaften auf Aktien* (Berlin: J. Guttentag, 1899³); first edition in 1886. For German accounting theory and practice before World War I, R. Fischer, *Die Bilanzwerte: Was Sie Sind und Was Sie nicht Sind* (Leipzig: Dielerich'sche Verlagsbuchhandlung, 1905). Sonja Gallhofer and James Haslam, "The Aura of Accounting in the Context of a Crisis: Germany and the First World War", *Accounting, Organizations and Society*, Vol. 16, 5/6 (1991), 487-520, esp. pp. 495-499. Jörg Baetge, et al., *Bilanzen* (Düsseldorf, 2001), 88-89. Adler H. Düring and K. Schmalz, *Rechnung und Prüfung der Unternehmen Kommentar zum HGB* (Stuttgart, 1987). Reinhardt Hanf, "Veröffentlichte Jahresabschlüsse von Unternehmen im Deutschen Kaiserreich: Bedeutung und Aussagewert für wirtschaftshistorische Analysen," *Zeitschrift für Unternehmensgeschichte* 23, no. 3 (1978): 147-51. B. Penndorf, *Geschichte der Buchhaltung in Deutschland* (Leipzig, 1913). Also Mark Spoerer, *Von Scheingewinnen zum Rüstungsboom: die Eigenkapitalrentabilität der deutschen Industrieaktiengesellschaften, 1925-1941* (Stuttgart, 1996), 62-97. Germany's most important accounting theorist was Eugen Schmalenbach, see Max Kruk, Erich Potthoff, and Günter Sieben, *Eugen Schmalenbach: Der Mann—Sein Werk—Die Wirkung*, ed. Walter Cordes (Stuttgart, 1984). Schmalenbach's *Dynamische Bilanz* (Köln/Opladen, 1962, 1st ed. 1919) went through many editions. For an English book on Schmalenbach, see Robert Locke, *The End of the Practical Man: Entrepreneurship and Higher Education in Germany, France, and Great Britain, 1880-1940* (Greenwich, Conn., 1984). Finally, see Hugh B. Markus, *The History of the German Public Accounting Profession* (New York, 1997).

essentially held outside or non-majority shareholders suspect, as potential underminers of a healthy firm if they distributed too much profit.

As corollaries to these overriding accounting objectives, a number of other principles guided 19th century German accounting practice, although these fundamentals of accrual accounting were not yet formally written into law or professional practices. The first was the principle of commercial realization (*Realisation*) whereby a firm records income (revenue) only when it has done everything necessary to earn it (made the goods, replied to an order, shipped the goods, and so on). Essentially, the principle allowed companies to count revenue and profits before cash was collected and cautioned businesses not to count profits until all the relevant activities related to sales were accomplished. Its counterpart on the expense side was/is the matching principle, which stipulates that only expenditures related to what you sold or the period of activity would be expensed. Hence, inventory is not expensed when it is bought or manufactured but rather when it is sold. Here there were more disputes, especially as the matching principle was applied or not to depreciation and amortization. Unlike Germany, general acceptance of the matching principle was not attained in the United States until just before World War II.

Closely related, the principle of prudence or caution in financial accounting whereby all assets should be valued at the lower of their cost or market value, while all liabilities should be valued at their highest rate. New investment too should be recorded at its present or lowest market value; then it should retain its book value over time in the interest of balance continuity. Any securities should also be estimated at their book value; gains counted as income only after they were sold. The exact manner of properly valuing each type of asset or liability remained subject to considerable debate among accounting theorists and subject to considerable variation among firms, but the earliest accounting worked within these broad principles. While many differences existed in how these principles were applied in Germany and United States, and even within each country, around the turn of the century, they were widely accepted by accountants, if not by all government regulators and managers. In these respects, 19th century German and American financial accounting principles were similar.

This accounting disjunction between assets and liabilities should establish firms as solid, ongoing concerns by not overstating the value of the enterprise; if anything, it should undervalue enterprise assets and profit in favor of caution to protect the solidity (capital maintenance) of the enterprise as an ongoing organism (hence the financial accounting conception term organic or static). Naturally, these principles favored long-term ownership relations and encouraged the accrual of open provisions or hidden reserves, which remain one of the most controversial aspects of German financial accounting to this day. Such practices biased entrepreneurs or senior management to withhold free cash flow, rather than disgorge earnings, the exact opposite norm as practiced today. Entrepreneurs and managers gained key financial advantages over time, especially to tide themselves over rough patches, smooth earnings, or stabilize dividend levels. Creditors (i.e. banks) should be able to count on an ongoing, continuous stream of payments; dividends could be made more stable, more like bond coupon payments, and should not be excessive. Metaphorically, one can view these principles as ensuring the reputable solidity of the enterprise rather than stressing its liquidity—its ability to generate surpluses that should flow to shareholders. Symbolically, one can view this as German balance sheets move from fixed assets down to liquid assets; while American balance sheets start with liquid assets then move down to fixed assets. (Before World War I, some American financial statements even followed the German pattern.)

In Germany, the late 19th century established financial statement principles that held until the late 20th century. Until the advent of International Financial Standards (IFS), the German General Commercial Code (HGB) and joint-stock company laws regulated financial reporting. It is telling that the U.S. system of financial reporting is addressed through securities regulation (*Kapitalmarktrecht*) instead of corporate or commercial law (*Gesellschaftsrecht, Aktienrecht, Handelsgesetzbuch*). German law permitted much greater room for maneuver by building reserves to ensure stability. It still remains greater in Germany than in the U.S. today. The U.S. accounting system, for instance, eventually eliminated the vague term of reserves and provided relatively clear rules about when contingent and other liabilities can be accrued.

Yet, as a Salomon Brothers report about Daimler-Benz 1992 listing using U.S. GAAP standards stressed, it would be “inaccurate to assume that the primary objective of

the creation of valuation reserves and provisions is to manage earnings to ‘fool’ investors.”¹⁵⁴ Reserves reflect the ingrained conservativeness of German accounting since 1873. Suspicion of “founders,” moreover, entrenched an attitude that shareholders could wreck reputable ongoing firms by pulling out their equity. Clearly the bias of these rules worked against arms-length investors, more suspiciously denigrated as “speculators.” Once August Thyssen, no bad speculator himself, made clear the terms he would accept a mortgage loan from a bank: "...we would like to know if the relevant bank wants to invest its own money in us with the mortgage or wants to trade it on the market: in the latter case, further negotiations would be pointless!"¹⁵⁵ In these accounting principles and attitudes, one can almost hear the traumatic experience of the early 1870s when fly-by-night, “mushroom” corporations defrauded investors. In the crisis-ridden 1920s, German entrepreneurs and managers topped off this fear of outside investors with an ugly nationalism and fear of foreigners.

Yet we should not generalize about German accounting from only the (external) financial accounting required by law or even from the public accounting literature. With the rise of big businesses, a strong demand for (internal) accounting and auditing by corporations or banks arose. In terms of managerial accounting (both financial and cost accounting), German corporate firms still developed sophisticated accounting innovations before 1914, and especially in the 1920s, without the benefit of a formalized profession of chartered accountants. If we examine the notoriously secretive Thyssen-Konzern, its internal reporting was at least as advanced as that found inside U.S. corporations. As early as the 1880s, Thyssen’s monthly reports sharply distinguished between new investments and operating expenses, which meant he employed rather sophisticated capital accounting techniques for the time, even compared to U.S. firms. Midland (Dow) Chemical Company, for instance, did not introduce regular monthly reporting or a strict distinction between current expenses and “betterments and additions” until 1898. DuPont did not introduce this distinction until after 1900. Except perhaps in “public service firms” in the U.S., depreciation, general overhead including interest on debt was handled

¹⁵⁴ Harris and Salomon Brothers, *Understanding German Financial Statements*, p. 4.

¹⁵⁵ Mannesmann Archiv: R 5 30 09 August Thyssen to Herr Lesenberg, Fol. 149-150, 27. Dec. 1883, and Fol. 191, 23. May 1884.

in a fairly sophisticated manner. Dow first began factoring in depreciation only after 1900.¹⁵⁶ In the nineteenth century, many American and English firms (such as the American Tobacco Company, McCormick Harvester, or Standard Oil) did not depreciate even on a yearly basis for the enterprise as a whole. They preferred the older renewal or replacement accounting method stemming from the railroad experience that “delayed the recognition of capital consumption until expenditures were made for renewals.” Carnegie Steel did not recognize depreciation in any systematic way, and excluded overhead costs, preferring to focus on a ruthless drive to cut prime manufacturing costs.¹⁵⁷ In spite of recommendations of its auditors, Dow did not include regular depreciation charges in its monthly *company*-level financial reports until after 1909. Thyssen (and Krupp) paid much more attention to overhead costs and depreciation than most American companies, including the pioneering Standard Oil.¹⁵⁸ In Germany, depreciation was handled in general in a more consistent, sophisticated manner.

This is an important perspective because, significantly, Germany had all the intellectual and managerial tools, let alone transatlantic access to accounting progress in the U.S., necessary to form a stronger accounting profession and standards for public reporting. The accounting historians, Hans-Ulrich Küpper and Richard Mettessich,

¹⁵⁶ This is a major thesis in Fear, *Organizing Control*. Also see Bernd Dornseifer, "Zur Bürokratisierung deutscher Unternehmen im späten 19. und frühen 20. Jahrhundert," in *Jahrbuch für Wirtschaftsgeschichte*, (1993), pp. 69-91. For Krupp and the GHH, see Wolfram Bongartz, "Unternehmensleitung und Kostenkontrolle in der Rheinischen Montanindustrie vor 1914: Dargestellt am Beispiel der Firmen Krupp und Gutehoffnungshütte (Teil II), *Zeitschrift für Unternehmensgeschichte* (ZUG), Jg. 29, Heft 2 (1984), pp. 86-97. See Margaret Levenstein, *Accounting for Growth: Information System and the Creation of the Large Corporation* (Stanford: Stanford University Press, 1998). Also Margaret Levenstein, "The Use of Cost Measures: The Dow Chemical Company, 1890-1914" in *Inside the Business Enterprise: Historical Perspectives on the Use of Information*, ed. Peter Temin (Chicago: Chicago University Press, 1991), pp. 71-116. Contemporary German accounting literature is Penndorf, *Geschichte der Buchhaltung in Deutschland*. Albert Ballewski and C.M. Lewin, *Der Fabrikbetrieb* (Berlin: Julius Springer, 1912), esp. pp. 37-69, 207-210. Richard Woldt, *Der industrielle Großbetrieb: Eine Einführung in die Organisation moderner Fabrikbetriebe* (Stuttgart: F. Steiner, 1911), pp. 66-79.

¹⁵⁷ Richard P. Brief, "Nineteenth Century Accounting Error," *Journal of Accounting Research* (Spring 1965), pp. 12-31, quote from p. 18. On American Tobacco Company, see Alfred D. Chandler, *The Visible Hand: The Managerial Revolution in American Business* (Cambridge, Mass.: Belknap Press, 1977), pp. 257, 267-269, 274, 279, 386.

¹⁵⁸ Bongartz, "Unternehmensleitung und Kostenkontrolle," pp. 86-89. Johnson and Kaplan, *Relevance Lost*, pp. 52-80. For examples see ThyssenKrupp Konzernarchiv: A/698/2 Revision des Wasserwerk Thyssen & Co., GmbH, 1910, 26 July 1911, Hof. A/681/2 Revision der 'Maschinenfabrik Thyssen & Co., 1910, Revisions-Büro der Thyssen'schen Werke [none]; Revision der Bilanz der Maschinenfabrik Thyssen & Co., 1913, Revisions-Büro der Thyssen'schen Werken: Hof. Mannesmann-Archiv (MA): R 1 35 83 Revision der Bilanz der Firma: Thyssen & Comp., Berlin 1913, 1 July 1914 Revisionsbüro, Der Thyssen'schen Werke, [none].

argued that Germany developed the most vibrant theoretical literature by the 1920s, but these did not necessarily translate into sophisticated financial statements designed for outside investors.¹⁵⁹ Internal managerial accounting often was well ahead of that required by law, outstripped the available theory, and more advanced than what could be found in contemporary accounting literature.¹⁶⁰ After 1900, in Germany an increasing disconnect arose between how firms accounted for themselves internally and what they disclosed to outsiders in their external financial reporting, while the U.S. began developing arguably modern financial statements by the 1890s. Why?

To understand, a glance at U.S. developments as a contrast is helpful. In the U.S., above all, the railways spurred new disclosure rules and innovated accounting practices. The sheer size of investments, the number of shareholders and bondholders, the distance separating investors (especially foreign investors) from the companies' management, the financial fragility, and the crucial public service provided by railroad companies helped to reshape the nature of investment and accounting information.¹⁶¹ By the early 1890s, foreigners held about 33 percent of the nominal value of all U.S. railroad securities.¹⁶² The large, international character of the market for their securities was a strong motive to improve reporting: "The man who lives in Europe and invests his money in securities of a great American railroad system, operating 6,000 or 7,000 miles of line, if he is to make an investment on his own knowledge based on figures, must demand from a railroad

¹⁵⁹ Hans-Ulrich Küpper and Richard Mettessich, "Twenty Century Accounting Research in the German Language Area, *Accounting, Business & Financial History* 15 (November 2005), pp. 345-410.

¹⁶⁰ Christian Leuz and Jens Wüstemann, "The Role of Accounting in the German Financial System," in *The German Financial System* (eds.) Jan P. Krahn and Reinhard H. Schmidt (Oxford: Oxford University Press: 2004), pp. 450-481, quote from p. 465.

¹⁶¹ See Alfred D. Chandler Jr., ed., *The Railroads: The Nation's First Big Business* (New York, 1965); and Chandler, *The Visible Hand* (Cambridge, Mass., 1977). Also Paul J. Miranti Jr., "The Mind's Eye of Reform: The ICC's Bureau of Statistics and Accounts and a Vision of Regulation, 1887-1940," *Business History Review* 63 (Autumn 1989): 469-509. Paul J. Miranti Jr., "Associationalism, Statism, and Professional Regulation: Public Accountants and the Reform of the Financial Markets, 1896-1940," *Business History Review* 60 (Autumn 1986): 438-68, esp. 447; and Miranti, "Mind's Eye of Reform," 475-85. The key figure was Henry Carter Adams. See Henry C. Adams, *American Railway Accounting: A Commentary* (New York, 1918). The Interstate Commerce Commission (ICC) published annually the *Statistics of Railways of the United States*.

¹⁶² Wilkins, *History of Foreign Investment*, 197-98; Baskin and Miranti, *A History of Corporate Finance*, 146-57. In 1855, the Frankfurt stock exchange alone listed eighty-two American railway securities, see Rainer Gömmel, "Entstehung und Entwicklung der Effektenbörse im 19. Jahrhundert bis 1914," in *Deutsche Börsengeschichte*, ed. Hans Pohl (Frankfurt am Main, 1992), 144.

corporation a very perfect system of accounting.”¹⁶³ After 1900 with the Great Merger Movement, the sheer size of concentration and capital in massive U.S. corporations began dispersing ownership more broadly, which increased the demand for external financial reporting. Increasing public scrutiny and uproar following panics, foundings and bankruptcies of “trusts,” and anger against the insider governance system of an alleged “money trust,” all spurred greater efforts for transparency and financial reform.

Under pressure from regulators and investors, especially regarding appropriate rates, American railroads began to provide public information comparable to that of modern financial reports, even if it continued to be unevenly applied across firms and states. Regulators focused considerable attention on accounting issues, such as depreciation, interest, and reinvested earnings. U.S. railroads also suffered both from horrible boom-and-busts, requiring large-scale reorganizations and debt-to-equity conversions, which led to significant financial innovations. Investment bankers came up with new forms of financial contracting, and courts reevaluated senior debt contracts, making them less stringent so that assets could not be seized as quickly. Financiers, managers, and accountants invented innovative financial strategies and improved accounting governance, shifting attention away from the balance sheet as a measure of future earnings and onto the income statement, which eventually became the underpinning of twentieth-century practices.¹⁶⁴ The Deutsche Bank and J.P. Morgan, for instance, transformed the debt of the Northern Pacific railway after its bankruptcy into a significant equity stake, which was subsequently sold to dispersed, new equity investors.¹⁶⁵ These same transatlantic connections spurred the creation of the German audit industry, such as with the founding of the first German audit company, the *Deutsch-Amerikanische Treuhand-Gesellschaft* (eventually *Deutsche Treuhand-Gesellschaft* or

¹⁶³ Adams, *American Railway Accounting*. John Maurice Clark, *Social Control of Business* (Chicago, 1926), pp. 320–33. Quote from William E. Hooper, *Railroad Accounting* (New York, 1915), 2.

¹⁶⁴ Peter Tufano, “Business Failure, Judicial Intervention, and Financial Innovation: Restructuring U.S. Railroads in the Nineteenth Century,” *Business History Review* 71 (Spring 1997): 1–40 (figure, p. 2). Also J. Bradford De Long, “Did J.P. Morgan’s Men Add Value?” in *Inside the Business Enterprise: Historical Perspectives on the Use of Information*, ed. Peter Temin (Chicago, 1991), 205–49; Slason Thompson, *Cost Capitalization and Estimated Value of American Railways: An Analysis of Current Fallacies* (Chicago, 1908).

¹⁶⁵ For specifics, see the Reorganization of the Northern Pacific Company, Plan of Reorganization, HADB (Haupt Archiv Deutsche Bank), A-1149; and Reorganization of the Northern Pacific Company, Announcement by the Reorganization Committee, HADB, A-1149. Also see Kobrak, *Cooperation, Conflict, Men, and Markets*, (forthcoming).

DTG) to act as trustee of Germans' American investments. The DTG began a long tradition in Germany of audit firms being closely related to banks, rather than being operated through sole proprietorships or partnerships. Most German audit firms were founded in the service of banks, which already had inside information, partially obviating the need for independent audits. The ties between banks and audit firms also called auditor independence into question.¹⁶⁶

The Interstate Commerce Commission (ICC) provided detailed financial statistics that were superior to certified financial reports produced by any companies at the time. Ironically, the architect of the ICC's first accounting and statistical reporting system was influenced by German economic thought and some of its applications derived from Germany's by-then nationalized railroads. For constitutional reasons, however, the ICC did not initially have the power to set rates or standardize accounting procedures. This situation changed with the Hepburn Act of 1906, which strengthened disclosure requirements ("publicity") and even empowered the ICC to require railroad companies to produce specific information on demand and under oath. With the passage of the Mann-Elkins Act in 1910, other "public" industries came under the ICC's reporting purview.¹⁶⁷ Thus the intense regulatory scrutiny of privately-owned railroads and utilities led to fundamental innovations and progress in U.S. financial statements.

Such regulations spurred the growth of the public accounting profession. In the decade prior to the war, the U.S. accounting profession transformed itself from one that merely monitored business to one in which CPAs worked "with businesses and federal regulatory agencies to collect and disseminate data so that business could earn a 'fair return' on their investments."¹⁶⁸ However ambiguously defined, this idea of "fair return,"

¹⁶⁶ For a first-rate history of the German audit industry, see Reiner Quick, "The Formation and Early Development of German Audit Firms," *Accounting, Business & Financial History* 15 (Nov. 2005): 317-43.

¹⁶⁷ Paul J. Miranti, Jr. "The Mind's Eye of Reform: The ICC's Bureau of Statistics and Accounts and a Vision of Regulation, 1887-1940," *Business History Review*, Vol. 63, Autumn 1989, pp. 469-508. Miranti, "The Mind's Eye of Reform," 469-509; Adams, *American Railway Accounting*; William Z. Ripley, *Railroads: Rates and Regulations* (New York, 1920), 487-521, 557-79. Tufano, "Business Failure, Judicial Intervention, and Financial Innovation." See Tufano for a description of financial innovations that included contingent-charge securities, deferred coupon debt, or voting trusts. Also Clark, *Social Control of Business*, 334-47.

¹⁶⁸ Quote from Previts and Merino, *History of Accountancy in the United States*, 239. Also see Miranti, "Mind's Eye of Reform," 485-93. On the politics of conferring this professional certification, see Miranti, *Accountancy Comes of Age*, 48-85. On "fair return" and "fair value," see James C. Bonbright, *Railroad*

introduced by the U.S. Supreme Court in 1898, helped transform the idea of equity and accounting. The court initiated it specifically in reaction to the “almost universal American practice of overcapitalizing new industrial and railway corporations,” known as “stock-watering.” The Great Merger Movement provided a boon to unscrupulous inside machinators to earn money through mergers and acquisitions. The notion that a company would offer a “fair return”—a stream of future income sustained by sufficient investment of earnings to attract investors and convince them to leave cash in a company in order “to build up the property” instead of boosting cash dividends—became increasingly important for the financial community in the 1920s.¹⁶⁹ The practice of “fair return” required an understanding of costs and how they could be controlled. In response to the regulation of public-service companies, accountants both inside and outside of corporations introduced their own standards for categorizing costs in a uniform fashion, determining direct and indirect costs, creating flexible budgets, adding full-cost income statements, as well as incorporating return-on-investment (ROI) calculations.

In Germany, by contrast, such industries were increasingly under public (state or municipal) ownership, which detached them from profitability considerations and from the need to report to outside investors. One contemporary German accounting theorist, who compared U.S. and German accounting, Kurt Schmaltz noted: “The final objective and final aim of business economics according to the American viewpoint is the profitability of capital, yes, of equity (*Aktienkapital*). In America, this attitude is so clear and so taken for granted, that a discussion about this goal simply does not exist.”¹⁷⁰ This makes Bismarck’s nationalization of railroads between 1876 and 1890, which removed about 2.8 billion marks of rail equity from capital markets and potential outside investors, such a crucial—inadvertent—step in the history of German accounting. Nationalization pulled the largest, most important, most attractive, most profitable sector of industry—with the largest base of outside or foreign investors for equity and debt—off of capital markets, thereby dramatically reducing the demand for sophisticated public financial

Capitalization: A Study of the Principles of Regulation of Railroad Securities (New York, 1920), quote from p. 53 on the impact of stock-watering.

¹⁶⁹ Clark, *Social Control of Business*, esp. 334–47; see his assessment on p. 345.

¹⁷⁰ Schmaltz, *Bilanz- und Betriebsanalyse in Amerika* (Stuttgart, 1927), 11, 31–65, 87–96, 137–39, quote on p. 91, from Gilman, p. 138. Schmaltz relied on Stephen Gilman, *Analyzing Financial Statements* (New York, 1925), Introduction.

reporting in Germany. While it actually promoted internally-oriented uniform accounting methods and regular reporting, nationalization detached railroad financial reporting from profitability considerations and, most critically, away from the income statement that signaled potential future earnings for outside investors. American railroads were “built to make money.”¹⁷¹

Another fateful step in the history of German financial reporting fell in 1891, when Prussia passed its income tax law, which made corporations taxable entities. Corporate financial statements provided the definitive or authoritative basis for the tax balance (*Massgeblichkeitsprinzip*), which was uniformly codified for all of Germany in the tax code of 1920. The desperate need for taxes after the war also introduced a number of different sort of taxes on corporations such as an revenue and capital transfers that led to many tax-inspired corporate maneuverings. Since the 1890s then, German financial statements were characterized by a tug-of-war between minimizing profits to reduce taxes and maximizing profits to attract investors. With a smaller base of outside investors, more inside governance, and more concentrated ownership than the U.S. after 1900, the law encouraged showing less profits. A 1996 commission of international accountants found that no other country in the world wound tax and commercial balances so tightly, a factor that naturally provided even more incentives to build reserves rather than show profits, as if already very private and secretive German entrepreneurs needed any more such incentives. Making German financial reporting the basis for tax assessment fundamentally transformed the purpose of accounting from providing transparent, “fair value” for investors to that of avoiding tax officials—one reason why tax officials focused so much on accurate depreciation schedules.¹⁷²

Finally, instead of a Great Merger Movement after 1900 that led to unprecedented “trusts,” Germany had a “Great Cartel Movement” that slowed concentration, helped keep ownership in the hands of families or single entrepreneurs, and eventually led to complicated, vertically integrated Konzerne. Konzerne were multisubsidiary operations,

¹⁷¹ Quote from a former statistician for the Lehigh Valley Railroad, quoted in J. Shirley Eaton, *Handbook of Railroad Expenses* (New York, 1913), quote on p. 5.

¹⁷² Merkt, *Unternehmenspublizität*, 71–72, with literature cited; Günter Wöhe, *Bilanzierung und Bilanzpolitik* (Munich, 1987), 55–59; Brigitte Eierle, “Differential Reporting in Germany—A Historical Analysis,” *Accounting, Business & Financial History* 15 (Nov. 2005): 286.

which entailed considerable partial ownership of other firms and increased the degree of interlocking directories and insider governance. With the growing reality of large-scale *Konzerne* (multisubsidiary operations) after 1900 (and the discrepancy became especially egregious in the 1920s), the legal definition of the firm increasingly did not correspond to the economic or strategic unity of firms, yet the legal definition of a stand-alone “merchant firm” determined how it would be taxed. A whole complicated body of tax law (*Organschaftstheorie*) evolved by the 1920s that attempted to square the legal definition of a firm with the obvious economic unity of *Konzerne*. The important point is that from at least the beginning of the 20th century, the way outsiders viewed corporations and the information presented to them compared to the way insiders actually ran corporations radically diverged in Germany.¹⁷³ However much controversy this system of insider governance, cartels, and banks engendered—and it did—the dominant attitude toward it was positive as it (allegedly) created dedicated long-term ownership or corporate relationships, stabilized prices, and helped to manage capitalist volatility.

In terms of financial reporting, however, it considerably dampened the demand for external financial reporting in favor of the responsible, private, if not secretive, owners or insiders. Innovations in accounting focused on improving it for factory or strategic decision-making (cost or managerial accounting) rather than financial reporting to outside investors. The implicit goals of minimizing distributable earnings and reducing taxes tended to make German accounting extremely conservative and risk-averse.¹⁷⁴ Strict bankruptcy laws only reinforced these underlying assumptions by placing a premium on maintaining the ongoing solidity of the enterprise with enough reserves to ride out bad times or to smooth dividend distribution. German disclosure laws still adeptly connected financial and tax reporting to the legal entity of the enterprise, rather than the economic unity of the enterprise, which hindered the construction of consolidated financial statements. Not until 1986 did the law require German companies

¹⁷³ Franks, Mayer, and Wagner, “Origins of the German Corporation.” Fear, *Organizing Control*.

¹⁷⁴ Leuz and Wüstemann, “Role of Accounting in the German Financial System.” Trevor S. Harris and Salomon Brothers, *Understanding German Financial Statements: Lessons from Daimler-Benz’s Listing* (New York: Salomon Brothers, Inc., October 7, 1993), pp. 2-4. Reinhardt Hanf, “Veröffentlichte Jahresabschlüsse von Unternehmen im Deutschen Kaiserreich: Bedeutung und Aussagewert für wirtschaftshistorische Analysen,” *Zeitschrift für Unternehmensgeschichte*, Jg. 23, 3 (1978), pp. 147-151.

to create consolidated balances for the first time, although many accountants had recommended them for some time.¹⁷⁵

Not surprisingly, these elements also slowed the development of uniform accounting principles and a chartered accounting profession, unlike in England or the U.S. Prior to 1914, neither the U.S. or Germany had unified accounting principles or a profession, but this would rapidly change in the 1920s and 1930s. Accounting principles were vague at best regarding the legal requirements for disclosure, consistency, and contents of financial statements. Germany at least had some minimal requirements, while the U.S. (excepting in key public service industries) were mostly voluntary. In both countries, accounting statements rarely divided operating from other expenses. Net income was often determined not by some systematic collection and ordering of revenues and expenses but on the basis of how high a dividend managers and owners wanted to pay. It was assumed that nearly everything earned in a given year would be paid out as a dividend, or held in trust (reserved) for a special purpose. Indeed in Germany, shareholders had a legal right to have their share of net income as a dividend.¹⁷⁶ But there was little in the way of auditing standards, principles of income determination, and liability to shareholders, especially to assessing the future earning power of their investment.

Even before World War I, American CPAs developed a concept of operating income, which was incorporated in public financial statements.¹⁷⁷ Some companies even added segment reporting, annual comparisons, and funds flow statements. American accountants (as a profession) and accounting theory began shifting their focus, more so

¹⁷⁵ Heinrich Dinkelbach, "Das Wesen und der Aufbau der industriellen Konzernbilanz," *Zeitschrift für Handelswissenschaftliche Forschung*, Jg. 35, Heft I/II (1941), pp. 55-66. Walter Cordes, "Die Bedeutung des Konzernabschlusses für die Konzernführung," *Wirtschaft und Wirtschaftsprüfung*, (Hg.) Konrad Mellerowicz und Jörg Bankmann (Stuttgart: C.E. Poeschel Verlag, 1966), pp. 50-68.

¹⁷⁶ See Jörg Baetge, *et al.*, *Bilanzen* (Düsseldorf: IDW-Verlag, 2001) pp. 88-89, also Adler H. Düring and K. Schmalz, *Rechnung und Prüfung der Unternehmen Kommentar zum HGB* (Stuttgart: Publ G, 1987). It is interesting to note that this right is lost once "income" becomes retained earnings at the end of the year; one of the stipulations of the Nazi Corporate Law of 1937 eliminated that right and capped dividends at 8% of nominal capital for any year.

¹⁷⁷ Fear and Kobrak, "Diverging Paths."

than in Germany, away from asset and capital valuation to income flows and made a greater distinction between liabilities and owner's equity.¹⁷⁸

Not surprisingly, manias, crashes, and panics often proved a catalyst toward greater standardization and systemization of accounting rules just as Enron or Worldcom spawned Sarbanes-Oxley. Financial scandals tainted American accountants in the late 19th century and early 20th centuries. Public pressure led to legislative correctives, but, to a much greater extent, American accountants *organized themselves* to try to correct weak financial accounting standards and applications. Well before World War I, accountants had their own journal, the *Journal of Accountancy* (1905). American accountants created their own national organization with individual members by 1916, the American Institute of Accountants in an effort to forestall criticism of the CPA (Certified Public Accountant) monopoly and federal legislation. Though not the first organization of this kind in the United States, it made great strides in setting admission requirements and professional standards for other accountants. By 1917, an effort was made to create model financial statements with the *Uniform Accounting*.

By 1914, thirty-three American states had licensing legislation. Individual states lost these powers more slowly in the United States than in Germany. Even today, some corporate laws differ from state to state, allowing for competition within formal and informal limits among the states to attract the lucrative business of state incorporation. Before the 1930s, securities law was largely a state affair in the United States. Nevertheless, even though the licensing and educational requirements for CPAs remain a state affair in the United States, accounting rules and audit practice are regulated on a national basis.¹⁷⁹

As in England, there was a widespread view that accountants performed a useful social role by protecting shareholder's interests by providing or verifying financial numbers. Long before World War I, American accountants were banding together in

¹⁷⁸ For the U.S., see Gary John Previts and Barbara Dubis Merino, *A History of Accountancy in the United States* (Columbus: Ohio State University Press, 1998) pp. 108-297

¹⁷⁹ For a good, brief discussion of American securities law before the 1930s, see James Burk, *Values in the Marketplace: The American Stock Market under Federal Securities Law* (New York: Walter de Gruyter, 1988), pp. 167-174. For post-1933 developments, see McCraw, *Prophets of Regulation* and Mark Roe, "Delaware's Competition," 117 *Harvard Law Review*, 588 (2003) on the limits of state power to determine corporate law.

state and national organizations to expand their role and increase their professionalism with education, professional norms, and internal review processes.¹⁸⁰ As Previts and Merino wrote about the importance of accounting to America's economic growth before World War I:

The birth of modern accounting societies, including their activities and publications, initiated the profession in the United States, culminating in the passage of CPA legislation. These organizations reflect the significance of accountancy to this period. Their existence and influence give testimony to the changes in accountancy in the United States' first industrial capital market era.¹⁸¹

In Germany, the accounting profession also developed, albeit somewhat later, was more academic, and less linked to practicing accountants in firms. As in the U.S., the literature on accounting in Germany boomed especially after 1900. One accounting historian related that over 800 works and 500 articles appeared in Germany about bookkeeping alone in the first decade of the 20th century, but little on accounting theory and practice.¹⁸² By the 1920s, however, Germans developed one of the most vibrant theoretical literatures on accounting, whose strands and ideas influenced most Continental accountancies.¹⁸³ The most important figure was Eugen Schmalenbach, the dean of German accounting and business economics.¹⁸⁴ He issued with his *Zeitschrift für handelswissenschaftliche Forschung* in 1906 (now *Schmalenbach Business Review*), which is still one of the major forums in Germany on accounting and management. Its earliest issues described accounting practices inside active firms. Cost accounting, critical analyses of financial statements, and finance, were major themes. Accounting fell under the rubric of "business economics" (*Betriebswirtschaftslehre*) and became institutionalized only in the 1920s. In 1919, Schmalenbach appeared with his "Dynamic

¹⁸⁰ Previts and Merino, *History of Accountancy in the United States*, pp. 140-149. By 1914, thirty-three states had given legal recognition to the accounting profession, among them New York, Pennsylvania, New Jersey, Ohio and Delaware in 1913 (p. 148).

¹⁸¹ Previts and Merino, *History of Accountancy in the United States*, p. 174

¹⁸² B. Penndorf, *Geschichte der Buchhaltung in Deutschland* (Leipzig: G.A. Gloeckner, 1913), p. 227.

¹⁸³ Küpper and Mettessich, "Twenty Century Accounting Research in the German Language Area."

¹⁸⁴ Max Kruk, Erich Potthoff, and Günter Sieben, *Eugen Schmalenbach: Der Mann—Sein Werk—Die Wirkung* (Hg.) Walter Cordes im Auftrag der Schmalenbach Stiftung (Stuttgart: Fachverlag für Wirtschafts- und Steuerrecht Schäffer GmbH & Co., 1984), pp. 26, 47-50. Robert Locke, *The End of the Practical Man: Entrepreneurship and Higher Education in Germany, France, and Great Britain, 1880-1940* (Greenwich, Conn.: JAI Press Inc., 1984), p. 156.

Balance,” which began to shift managerial attention to the income statement away from the balance sheet, but the idea was to use the profit-loss statement as a “compass” to aid strategic decision-making, rather than transparency for outside investors. From his Treuhand seminar, founded in 1913, he produced a steady stream of students who became chartered accountants or moved into executive life in business for many of the top firms in German business.¹⁸⁵

Schmalenbach’s ideas, however, did not immediately have a large practical footprint on professional practices for a number of reasons.

Tellingly for Germany, accounting regulations derived from the various local municipalities (Lübeck, Hamburg, Bremen), then the regional Chambers of Commerce, rather than the central government or federal states. Not until 1900 did auditors become chartered by law across Germany by Chambers of Commerce, but their licenses were valid only for that respective locality. Not surprisingly, these new accountants and auditing firms had close ties to their specific localities and regions, which called into question their objectivity once again. The firms’ personnel needed to engender a good deal of personal trust before a business would open their books, which partially defeated an audit’s basic objectives. Then, without uniform standards, knowing the auditing firm was critical. German particularism asserted itself in this manner as well. Not until 1926, however, were the tasks and admission requirements established uniformly across Germany by the *Deutsche Industrie- und Handelstag*.¹⁸⁶ A controlling body for the German profession was first created in 1931 when it established the first rigorous, standardized testing and admissions procedures for licensing auditors.

¹⁸⁵ Heike Franz, “Kulturelles Milieu und Disziplinbildung: Die Entstehung der Betriebswirtschaftslehre in Deutschland 1900 bis 1933,” in *Wissenschaftsgeschichte Heute*, (Hg.) Jürgen Büschenfeld, Heike Franz und Frank-Michael Kuhlemann (Bielefeld: Verlag für Regionalgeschichte, 2001), pp. 251-277. On universities and business economics, see Heike Franz and Alfred Kieser, “Die Frühphase der Betriebswirtschaftslehre an Hochschulen (1898-1932): Von der Handelstechnik zur Betriebswirtschaftslehre als Wissenschaft,” in *Entwicklungen der Betriebswirtschaftslehre: 100 Jahre Fachdisziplin—zugleich eine Verlagsgeschichte*, (Hg.) Eduard Gaugler und Richard Köhler (Stuttgart: Schäffer-Poeschel Verlag, 2002), pp. 60-85, esp. pp. 71-76. On Schmalenbach, see Kruk, Potthoff, Sieben, *Eugen Schmalenbach*, pp. 50-57.

¹⁸⁶ Henning, “Die externe Unternehmensprüfung,” p. 17-18. Bankmann, “Entwicklung des Wirtschaftsprüferstandes,” pp. 174-175. Markus, *History of the German Public Accounting Profession*, pp. 1-6.

The growth of the profession was also delayed in Germany by controversies. Considerable differences among rival procedures, fees, admission standards existed. After 1900, for instance, one of the more contentious issues was whether the profession required only university graduates (in short supply), whether practical experience was sufficient, and even if they were graduates, how many years of business experience was needed. This question was not adequately solved until 1961. Differences among chartered and unchartered accountants remained fuzzy. Another controversy concerned the question whether auditing firms should be partnerships along Anglo-Saxon lines or whether they could be corporations (later decided in terms of the latter). Tension between lone practitioners and bank-oriented investment trusts continued. Finally, the auditing firms that did exist had no common professional standards, which did not enhance the profession's trustworthiness. Although many of these disputes plagued the American profession, they were discussed and to varying degrees resolved, most importantly, by members of, at first state, then national associations of certified accountants by 1918.¹⁸⁷

The German university system built on humanistic studies of the German cultural elite (*Bildungsbürgertum*) also made it difficult to assert such "unspiritual" and money-oriented accounting and management studies. German "national economists" initially resisted the introduction of business economics, what they then called "private economics" and derogated it as "dreary teachings about profit" into universities. Considerably controversy surrounded the 1919 appointment of Schmalenbach to a new chair at the rechartered University of Cologne. Even where specialized business schools (*Handelshochschulen*), gave instruction in accounting, the course offerings were general and focused on the economics of the firm, not accounting theory or practice. Resistance from many industrialists to open their books slowed the attempt to make accounting and management academic disciplines.¹⁸⁸

¹⁸⁷ Hugh B. Markus, "Der Wirtschaftsprüferberuf: Eine geschichtliche Kurzfassung," *Wirtschaftsprüferkammer Mitteilungen*, Jg. 31 (Feb. 1992), pp. 1-10. Markus, *History of the German Public Accounting Profession*, pp. 12-17. Previts and Merino, pp. 175-234.

¹⁸⁸ One example brilliantly illustrates the prevailing wind in the face of the profession. The future director of the Deutsche Bank, Hermann Josef Abs, once horrified his teacher, who could not believe that such a smart student wanted to pursue such an "unspiritual" profession of becoming a businessman. Lothar Gall, *Der Bankier Hermann Josef Abs: Eine Biographie* (München: C.H. Beck, 2004), pp. 18-19. Heike Franz,

The upshot was that in comparison to their English and American counterparts, German accountants were few in number and fragmented in their organizations. As in England, most of the professional training was on the job, but in Germany the much lower number of practitioners limited the number and training of new entries. Even before America's entry into World War I, American accountants were organized into one effective group, the American Institute of Accountants formed in 1916, but state and national existed as far back as the turn of the century. These societies articulated principles of financial reporting and auditing, developed accreditation standards, and represented the profession and its interests with the general business community, banks, governments, and stock exchanges. Although American accountants had professional squabbles to contend with and had to struggle to get universities to include accounting education as well (until 1900 there were no American institutions offering degrees in accounting), by 1930 three hundred schools offered undergraduate or graduate degrees in accounting. Thirty-five percent of all native born practitioners held college degrees.¹⁸⁹ In 1930, England had 17,172 qualified accountants, who belonged to three accounting associations. By contrast, in 1932, Germany possessed just 457 chartered accountants, who, despite their lower numbers, were divided into five main organizations and a lot of smaller ones, in which lawyers and others providers of business services participated. Conflicts between sole practitioners and larger trust companies, many of which operated under the auspices of banks, contributed to the profession's inability to mount a united front against government regulators, lawyers, and companies.¹⁹⁰ The state even operated one of the largest audit firms, the *Deutsche—Revisions- und Treuhandgesellschaft*, which in July 1919 employed approximately 50 accountants in its Berlin office.¹⁹¹ American

“Kulturelles Milieu und Disziplinbildung: Die Entstehung der Betriebswirtschaftslehre in Deutschland 1900 bis 1933,” in *Wissenschaftsgeschichte Heute*, (Hg.) Jürgen Büschenfeld, Heike Franz und Frank-Michael Kuhlemann (Bielefeld: Verlag für Regionalgeschichte, 2001), pp. 251-277. On universities and business economics, see Heike Franz and Alfred Kieser, “Die Frühphase der Betriebswirtschaftslehre an Hochschulen (1898-1932): Von der Handelstechnik zur Betriebswirtschaftslehre als Wissenschaft,” in *Entwicklungen der Betriebswirtschaftslehre: 100 Jahre Fachdisziplin—zugleich eine Verlagsgeschichte*, (Hg.) Eduard Gaugler und Richard Köhler (Stuttgart: Schäffer-Poeschel Verlag, 2002), pp. 60-85, esp. pp. 71-76.

¹⁸⁹ Previts and Merino, *History of Accountancy in the United States*, p. 256.

¹⁹⁰ Markus, *History of the German Public Accounting Profession*, pp. 1-62. According to Jörg Bankmann, by 1934 Germany had 770 public chartered accountants (defined in the narrowest sense) and 92 auditing companies. Bankmann, “Entwicklung des Wirtschaftsprüferstandes,” p. 178.

¹⁹¹ Hugh Marcus, “British and US Accounting Firms in Germany,” unpublished manuscript, p.3.

and British accountants also profited from a long tradition of interaction, which led to the formation of multinational accounting service companies with senior partners from both countries, for example, Peat, Marwick, Mitchell, which resulted from the chance meeting of Sir William Peat and James Marwick in 1911.¹⁹²

In summary, then, as Germany emerged from World War I, even though it had national disclosure requirements for public corporations and a vibrant theoretical accounting literature and practice, professional accountants had not established as strong an institutional framework, educational standards, and international connections as their American counterparts. Most decisively, whereas accounting rules were defined and in large part enforced by accounting professional groups in the U.S. and Britain, in Germany courts made the most important decisions regarding accounting regulations. Lawyers and civil servants dominated the accounting profession rather than professional accountants. Audited financial statements were more the exception than the rule in both countries, but American accountants were beginning to push with a stronger voice for employing concepts such as operating income, full cost, and consolidation, essential for outside investors to value the potential earning power of large, complex firms. Most importantly, American accountants, unlike their German counterparts, were spearheading reforms and integrated into the institutional changes demanded by government and society at large.

We want to stress that these precedents did not entail a path-dependent trajectory until they were reinforced by choices and events that took place after World War I. One could say that this system of interlocks and insider governance became increasingly nationalized after the trauma of the loss of the war. A hypernationalized Deutschland AG was founded only after WWI. Fear of “foreignization” (*Verfremdung*) became a virulent hot-button issue after the war. This, too, discouraged giving away the corporate secrets.

What made investing work so well prior to 1914 during the first wave of globalization was a highly personalized, transnational network of intermediaries who were actively involved in corporate control. A small class of investors often *knew* one another personally, so they could supplement accounting reports with other information.

¹⁹² Mark Stevens, *The Big Eight* (New York: MacMillan, 1981) p.4

Investing was a sort of insider lending.¹⁹³ Up to World War I, these intermediaries were so strong that the introduction of different disclosure practices had little effect on domestic and cross-border finance. This network alleviated many information asymmetries and partially obviated the need for extensive public accounting, at least for well-connected larger investors. Prior to World War I, there was also a good deal of congruence between accounting theory and principles in both countries, though their application remained problematic. Accountants focused on the balance sheet instead of the income statement as a reflection of the firm's value. Rules regarding depreciation, replacement, and expensing remained vague at best. The dominant owners' or managers' determination of how much of a company's cash to issue as dividends to shareholders guided the preparation of income statements, rather than clear principles of matching costs to revenues. By and large, insiders decided what "belonged" to shareholders in retained earnings.

In spite of the lack of uniformity in both the U.S. and German financial reporting practices, different purposes and attitudes underlay their construction that were subsequently solidified after 1918. American accounting regulations became more concerned with making capital markets work more transparently, efficiently, and fairly, while German accounting regulations anchored control in the hands of owner-managers in the service of stabilizing state and society. These different orientations still shape how American and German accountancy deals with the challenges and opportunities of globalized capital markets. Best practice financial reporting made little headway because the German accounting profession did not control its own fate. Accounting principles

¹⁹³ Naomi Lamoreaux, *Insider Lending: Banks, Personal Connections, and Economic Development in Industrial New England* (Cambridge, U.K., 1994); Christopher Kobrak, *Cooperation, Conflict, Men, and Markets: Deutsche Bank and the United States from 1870 to the Present* (Cambridge, U.K., forthcoming); Gary John Previts and Barbara Dubis Merino, *A History of Accountancy in the United States: The Cultural Significance of Accounting* (Columbus, Ohio, 1998), 208–23; Paul J. Miranti Jr., *Accountancy Comes of Age: The Development of an American Profession, 1886–1940* (Chapel Hill, 1990). For a good, brief discussion of American securities law before the 1930s, see James Burk, *Values in the Marketplace: The American Stock Market under Federal Securities Law* (New York, 1988), 167–74. For post-1933 developments, see Thomas K. McCraw, *Prophets of Regulation: Charles Francis Adams, Louis D. Brandeis, James M. Landis, Alfred E. Kahn* (Cambridge, Mass., 1984); Mark Roe, "Delaware's Competition," *Harvard Law Review* 117 (2003): 588, on the limits of state power to determine corporate law.

and rules rarely evolved out of professional experience and were not directed by independent, professional bodies.¹⁹⁴

IV. Conclusion:

We have argued here that the origin of German corporate governance structures reflected fundamental aspects Germany's political power structure and deep-seated attitudes about capitalism, which were reinforced by the perception of the 1873 crash—not an inherent relative backwardness—that over time reinforced one another into a durable framework of corporate governance. We want to stress, however, that not until after WWI did Germany (and many other Continental European countries) fundamentally go down a different path because of the traumas of the post-WWI world. By 19th century standards, however, the level of formal disclosure, publicity requirements, and investor protections were fairly high in Germany, which helped lead to a relatively high level of equity finance for industry.¹⁹⁵

Some commentators have seen this process in both countries relatively narrowly. In *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance*, Roe argued that “American corporate structures are in considerable part the result of political decisions, many long forgotten, about the organization of financial intermediaries.”¹⁹⁶ These political decisions were a product of particularly American circumstances, which include: American populist ideology, which emphasized the dangers of large powerful economic and political institutions; interest group politics, which allowed small financial institutions, small businesses, and managers to resist effectively financial concentration, and, finally, federalism, which gave local interests a loud voice. The fact that non-American systems have dealt with the technologically-driven economic necessity faced by all modern firms to achieve greater economies of scale and scope differently than American firms proves for Roe that America's model of

¹⁹⁴ Heinz-Dieter Assmann, “Corporate Governance im Schnittfeld von Gesellschaftsrecht und Kapitalmarktrecht,” *Bankrecht und Kapitalmarktrecht in der Entwicklung*, (Hg.) Jens Ekkenga, Walther Hadding, Horst Hammen (Berlin: Erich Schmidt Verlag, 2003), pp. 1-17. Merkt, *Unternehmenspublizität*.

¹⁹⁵ Julian Franks, Colin Mayer and Hannes F. Wagner, “The Origins of the German Corporation—Finance, Ownership and Control, 1 March 2005, available at >papers.ssrn.com<, accessed 15 July 2005. Also Julian Franks, Colin Mayer, and Stefano Rossi, “Ownership: Evolution and Regulation,” 25 March 2005, available at >papers.ssrn.com< accessed 15 July 2005.

¹⁹⁶ Mark Roe, *Strong Managers, Weak Owners* (Princeton: Princeton University Press, 1994) Preface.

distant shareholders and centralized management was determined by the particularities of American political history.

But Roe's conclusion about the role of large banks, one of the key differences between the two systems, is very narrowly focused. He concludes merely that, although German banks were under similar pressures to those that gave rise to American restrictions on large, universal banks, anti-big-bank feeling was less strong in Germany and politics less conducive to interest group pressure:

Relative weakness of both the sentiment and interest groups is part of the answer. Political structure and *different* formal limits are also important. The German political structure dilutes the political effect of both anti-big-bank popular opinion and anti-big-bank interest groups. Citizens vote for a party, which gets a number of parliamentary seats proportionate to its percentage of the national vote. Because the party is more important than the candidate, local bankers and managers (and their campaign contributions) play a less important role than they do in U.S. congressional elections.¹⁹⁷

Roe neglects to discuss at all the historical sequence of German responses to corporate governance issues and some vital elements of Germany's political development.

Moreover, in contrast to Roe's view, in the late 19th century, Germany had many small financial institutions analogous to those in the United States, which could have served as a potential political counterweight to big banks. In fact, they did try to oppose collectively the economic power of big banks. Banking, like nearly all other sectors of the German economy, was organized into interest groups, through which small institutions could represent their interests much more effectively than through parties or parliament. Inside these groups many conflicts were fought out and, at times, segments of these groups split off to form their own interest groups, when consensus within the larger group was impossible.

Most importantly, whereas Roe relegates political, social ideology to one of many factors that explain American and German corporate governance systems, there is much evidence that attitudes were by far the most important causal influence. Fundamentally different attitudes, values and preferences regarding markets, cartels, banks, bankers, corporations, the purpose and norms of financial reporting, the value of cooperation and

¹⁹⁷ Roe, *Strong Managers, Weak Owners*, 213.

relationships, and a conception of liberalism propelled corporate governance change. As we have stressed throughout, the differences were often a matter of degree and there was a high degree of congruence and parallels in the discussion, but the dominant attitude helped legitimize political decisions.

Although Roe cites some of the leading exponents of Germany's special and late industrialization, he does little to integrate them into his assessment of the development of German corporate governance. The structure and development of German corporate governance must be seen in light of long-standing and deeply held German attitudes about capitalism, individualism, and the State.

After 1873, German reformers learned hard lessons about markets, banks, and corporations. They needed better rules, regulations, institutions, rules of the game to tame markets and moderate volatility. For instance, effective and liberal securities markets actually expands the need for regulation to create efficiencies and transparency. Germans introduced model corporate governance legislation and auditing standards (for the time) that even Americans could praise.¹⁹⁸

It is important to contrast these developments in Germany with attitudes and changes in the United States during the same period. In some sense, American financing fell into the hands of banks during the same period, but with many significant differences. First, the banks acquired their power in companies during the last few decades before World War I, because of the sale of privately held companies by their original founders and because of the economic preference to consolidate smaller companies in many industries. Second, this process was accompanied by a widespread outcry against the power of bankers, even in the absence of economic crisis.

¹⁹⁸ It is also no surprise that this period gave birth to the "New Historical School," fundamentally an institutional school of thought as its American contemporary counterpart was known. They believed that history (evolutionary theory), policy and institutions (formal norms), customs, ethics, and culture (informal norms); brackets refer to their modern semantic equivalents. The social reformers of the diverse New Historical School of German Economics (with some exceptions on both the right and the left) led by Gustav Schmoller, Max Weber, Lujo Brentano were essentially liberal progressives who felt that markets needed some sort of market-enhancing institutions (stock exchange laws, better corporate governance), market regulations to tame their excesses (cartel office, tariffs), or reforms to address the social question (unions, insurance, safety laws). The market enhancing or ameliorating aspects of the New Historical School.

Even divisions in the banking sector could not loosen the hold of large banks hold on capital markets. To be sure, many of their clients had won a good deal of financial independence before the war and many new industries, less tied to bank financing, were developing. But the breakdown of the world economic order, the destruction of monetary values, and above all the new constellation of German investment requirements and American capital export and expansion had weakened the position of bankers in the German economy. The banking sector's ability to defend itself from government and public attacks through representative organizations was impaired, but not eliminated, by a deep division between the large universal banks, small private banks, and more local savings banks. "As universal banks handled, the large banks on the financial markets were able to launch securities, advise clients about the purchase of securities, hold securities for customers for security and assume voting rights at shareholders annual meetings. The private banks considered these activities with securities burdensome and wanted to limit the involvement of the large banks."¹⁹⁹ The efforts of small banks within these sector organizations to limit the competitive advantages of the big banks in the 20s and 30s bore little or no fruit.²⁰⁰

In the 1930s, the political response to the perceived shortcomings of the banking system translated into direct State control. By 1931, 35% of the German banking system was owned by the state and the rest tightly controlled by the quasi-government authority of the Reichsbank, Germany's central bank. The National Socialists, despite their contempt for finance capital, left most of the structures of German corporate governance in place, while modifying them enough to increase state and party control of those mechanisms.²⁰¹ In spite of American and German views that the banks and business helped bring National Socialism to power, Germany kept many key institutions after World War II, including the large banking role in corporate governance. Although viewing the role of banks in the German economy and German corporate governance over time as static ignores the historical record, they have evidenced a great deal of

¹⁹⁹ James, *Verbandspolitik*, 13-15.

²⁰⁰ James, *Verbandspolitik*, 62.

²⁰¹ See Christopher Kopper, *Zwischen Marktwirtschaft und Dirigismus* (Bonn: Bouvier Verlag, 1995) and Harold James, *The Deutsche Bank and Nazi Economic War Against the Jews* (Cambridge: Cambridge University Press, 2001) for excellent discussions of the relationship between the banking system and the Third Reich.

staying power in the face of totalitarian regimes and Allied occupiers zealously intent on reforming the German banking system.²⁰²

In short, this article has offered evidence that confirms two of Roe's thesis: that history counts in understanding today's national systems of corporate governance and the weight of historical path dependencies presents a significant obstacle to further international convergence. It also suggests that his work to date underestimates the importance of general cultural and social differences in the determination of corporate governance institutions, at the very least in the German case but perhaps also in the American. Many aspects – including some of the attitudes that originally inspired the form of institutions – of German corporate governance have persisted over time and are shared across a broad political spectrum. They have tended to transcend parties and periods, from Kaiser Reich, to social democracy, to National Socialism, and then back to social democracy, suggesting a causal explanation in deep-seeded attitudes about capitalism and society. To be sure, Germany's new tax system, banking capital shortages, international investor pressure, and, lastly, European efforts to ease barriers to market entry and capital flows, are pushing Germany toward a system of corporate governance more in line with that in the United States. But it is still not clear how much convergence will occur in national systems of corporate governance, or at what pace and with how many hiccups. The evidence suggests that, insofar as changes have occurred to the German system in the last decade, greater integration of European and global equity capital markets have played a larger role than political conflicts among different German interests groups. But culture and many of Germany's most power corporate stakeholders may not give up easily.

²⁰² Carl-Ludwig Holtfrerich, "The Deutsche Bank 1945-1957: War, Military Rule and Reconstruction," in Gall, et al. *The Deutsche Bank*, 357-523. Complete note with Gerald Feldman, Tilly, Fohlin.

Milestones in German Financial Statement and Disclosure Reforms

1861	ADHGB § 239 § 31 § 214	Various articles for registering the firm, registering change in the statutes, mandatory (internal) record-keeping with legal status, and filing of general assembly meetings; Executive board must prepare balance statements for shareholders; Minimum stipulations for constructing balances introduced Company required to file minutes of general meeting at register court.
1870	Aktiengesetz [joint-stock company law] § 239	Joint-stock companies freed of concessions, but required to have a supervisory board; Shareholders gain right to sue executive or supervisory board members; Mandatory publication of balance (not profit-loss) statements for joint-stock companies in business newspapers—inaccuracy made punishable by law Introduction of conservative valuation and realization principles.
1877	Insolvenzrecht	Establishes strict bankruptcy laws primarily in the interests of creditors (i.e. banks).
1884	Aktiengesetz § HGB 209 § HGB 239 § HGB 185	Mandatory auditing only for <i>founding</i> a joint-stock company, founders named; strengthened shareholder protections (i.e. to change company statutes, hiring and firing executive board members); greater delineation of supervisory board responsibilities Supervisory boards could call for special corporate audits with a majority; Mandatory publication and commercial court registry of both balance and profit-loss statements for joint-stock companies and company limited by shares with silent partners; Guidelines for depreciation, prudence or caution valuations, and legal reserve created. Failure to create <i>legal</i> prospectus and listing rules for stock exchange in interest of “self-government” (<i>Selbstverwaltung</i>), but introduction of mandatory filing of prospectus and publication in Berlin newspapers
1891	Tax Reform § 19	Prussian Income Tax levied on AGs and GmbHs, public financial statements considered definitive basis for tax assessment
1892	RGB	Introduction of GmbH legal form (presumed to be smaller businesses at the time) with no disclosure requirements except for those with immediate business or credit relations
1896	Stock Exchange Acts § 38 (BörsG) § 39 § 43	Prospectus filing at Board of Admissions of stock exchange, which inspected information and contained specific material; must be published at least six days before trading starts Company must have incorporated at least one year prior to IPO; must publish its first financial statement Penalties can be levied if prospectus incomplete or inaccurate
1897	HGB § 241	Company organs required to make full accounting information public (up to this point, many shortened and

	§ 314	without business reports) and file with commercial register Penalties against dishonest business dealings and fraudulent publication
1905	Imperial Court ruling on § 314	Corporate organs required to make accounting public “due to the public interest on the healthy development of shareholding as well as to protect the public against dishonest business practices (<i>unlautere Geschäftsgebaren</i>)”...in case of conflict the interests of the shareholders fall behind that of the public
1908	Imperial Court ruling on § 314	Required disclosure “should at the same time act in the general interest and as a protection against damaging and dishonest business practices, not merely in the interest of the general assembly of participating shareholders, but also for the corporation in itself, as well those who already stand in contractual relationship to it or who want to enter into a such a relationship with it, be it as a shareholder or creditor.”
1915	Imperial Court ruling on § 314	“Apparent sense and objective [of the law] is not only to demand truth and clarity for those who hold the director of the company to the correct path and to protect the shareholders [<i>Gesellschafter</i>], but rather more importantly to secure the health of the entire economy against the dangers that threaten conditions precisely arising from the economic form of the joint-stock company because of lack of transparency.”
1917	Walther Rathenau	Initiates concept and discussion of the “Unternehmen an sich”: “Big business today is no longer a mere collection of private-legal interests, but is rather—singly and collectively—a national economic factor that belongs to the whole. From its origins it indeed still carries, rightly or wrongly, its private-legal elements of a pure profit-making company, but meanwhile it has been put into service of public interests and thereby has created a new reasons for its existence.”
1919	Eugen Schmalenbach	Publishes <i>Dynamische Bilanz</i> , introducing modern accounting principles and advocating more “dynamic accounting” focusing attention on the income statement, size of flows in and out of the firm that define performance, not assets, in order to assess future earnings potential. Advocated wide-ranging standardization of financial reporting and disclosure across firms. Since 1913, offered influential “Seminar für Treuhänder,” training and testing many of the first German chartered accountants. Heavily influences German accounting profession (especially managerial and internal accounting), but not organization of public financial statements.
1931	Emergency Decree	Rigorous, standardized testing and admissions procedures for licensing auditors established; Unification of German accounting profession; Mandated yearly audits for public companies and revised organization of corporate financial statements.
1937	Aktiengesetz	Introduction of <i>Führerprinzip</i> (leadership principle), whereby the executive board has final responsibility for the firm “in the common interest of the people and nation (Reich);” Institutionalizes 1931 emergency decrees for mandatory

	§ 110	year audits; Additional transparency for voting whereby shareholder must list ownership or voting by proxy
1959	BGBI I 1959, pp. 789-795	Specifies required new organization of the profit-loss statement, expanding it from 9 to 17 lines for expenses, six to 14 for profits, including gross profits
1965	Aktiengesetz § 20 § 177-178 § 329-338	“gläsernen, aber verschlossenen Taschen” Strengthened minority shareholding rights; Required disclosure of shareholdings of 25% and 50%; Greater specification of financial statement publicity, improved stipulations to limit silent reserves; New standards of publicity for <i>Konzern</i> holding companies in the form of an AG
1965	EC Accounting Study Group formed	First preparations under Walter Elmendorff for harmonized European accounting, auditing, and publicity standards
1966	Segré Report	Recommends minimum levels of harmonization for investor protections, capital market entry information; points out difficulties involved (not acted upon until early 1980s)
1968	First Council Directive 68/151/EEC	Establishes EEC-wide company register for limited liability companies with minimum disclosure rules to coordinate safeguards for protection of members and others (updated 2003/58/EC; companies able to file electronically)

Source: Merkt, *Unternehmenspublizität*.