

**Between Rent-Seekers and Free Marketeers:**

**The Economic Policy Preferences and Political Influence of  
German and Swiss Pharmaceutical Multinationals and Banks**

**PhD Thesis at the London School of Economics and Political Science**

**Submitted by Nico Baljer, October 2000**

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## Abstract

The purpose of this study is to analyse the economic policy preferences and political influence of a sample of German and Swiss pharmaceutical multinationals and banks. Put differently, the goal is to examine whether these MNEs have the will, and the political clout, to promote a liberal economic order or whether they seek to distort, or even suspend, the free formation of prices. In a sense, this study is thus a two-step procedure: first, it will analyse the formation of MNEs' preferences and then, second, it will examine how these preferences translate into political influence and policy outcomes. The focus of the analysis will be on the home country and the EU level of policy-making during the period from 1985 to 1995. Economic policy preferences will be explained as the result of the interaction of three factors: the *extent and nature of MNEs' internationalisation process*, their *business focus* and *sectoral characteristics*. With regard to policy outcomes and MNEs' influence over them, it will be argued that also three factors need to be considered: *interests*, *institutions* that link MNEs to the policy-making process and *changing economic and political circumstances*, which affect perceptions of self interest and institutions. Particular focus will be on the impact of circumstances on the preferences of the government, the degree of opposition from other domestic groups and the extent to which MNEs can use their internationalisation process for political leverage.

Regarding MNEs' economic policy preferences, it will be pointed out that both the six pharmaceutical MNEs and the six banks were generally supportive of free markets, although there were also a few grey areas. When it came to their political influence, the picture was less clear cut since the extent to which MNEs could shape policy outcomes varied not only between pharmaceutical MNEs and banks, but also across policy issues within the two sectors. In general, the proposed explanatory framework could explain many of these complexities, although there were a few exceptions and qualifications.

# CONTENTS

<i>Abstract</i>	ii
<i>Tables</i>	iv
<i>Figures</i>	v
<i>Acknowledgements</i>	vi
1 Introduction: The Economic Policy Preferences and Political Influence of Multinational Enterprises (MNEs)	1
2 Business Focus and Internationalisation Processes of the Twelve MNEs	35
3 The Economic Policy Preferences of the Six Pharmaceutical MNEs and the Six Banks	69
4 Economic Policy-Making in Germany and Switzerland	99
5 The Political Influence of the Six German and Swiss Pharmaceutical MNEs	133
6 The Political Influence of the Six German and Swiss Banks	165
7 The Twelve MNEs' Political Influence at the European Level of Policy-Making	192
8 Conclusion	227
<i>Bibliography</i>	241
<i>List of Interviewees</i>	268

## Tables

Table 1.1	The selected German and Swiss Pharmaceutical MNEs and Banks	4
Table 1.2	World Sales of MNEs' Foreign Affiliates and World Exports, 1984-1993	9
Table 1.3	Foreign Direct Investment Inflows and Outflows, 1983-1995	10
Table 1.4	Selected Fiscal Incentives Offered Foreign Investors in the early 1990s	12
Table 1.5	Government Spending as Percent of Gross National Products	26
Table 1.6	Financial Services' Exports of Selected Countries	32
Table 2.1	Sales, Employment and R&D Figures for the Three German Pharmaceutical MNEs	36
Table 2.2	Sales, Employment and R&D Figures for the Three Swiss Pharmaceutical MNEs	37
Table 2.3	International Sales Figures for Hoechst, Bayer and BASF	41
Table 2.4	International Sales Figures for Roche, Sandoz and Ciba-Geigy	45
Table 2.5	Figures relating to the Extent of the Six Pharmaceutical MNEs' Internationalisation Process	49
Table 2.6	Balance Sheet Size and Employees of the Three German Banks	52
Table 2.7	Balance Sheet Size and Employees of the Three Swiss Banks	53
Table 2.8	Figures relating to the Extent of the Six Banks' Internationalisation Process	63
Table 4.1	German Economic Growth and Unemployment, 1960-1997	111
Table 4.2	Swiss Economic Growth and Unemployment, 1960-1997	124

## **Figures**

Figure 1.1	Explanatory Framework for MNEs' Economic Policy Preferences	22
Figure 1.2	Explanatory Framework for MNEs' Political Influence	23
Figure 1.3	Pharmaceuticals Exports of Selected Countries, 1995	32
Figure 4.1	German Government Expenditure as a Percentage of GDP	110
Figure 4.2	Swiss Government Expenditure as a Percentage of GDP	123

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**N.B.**

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# 1

## **Introduction:**

### **The Economic Policy Preferences and Political Influence of Multinational Enterprises**

Whenever something goes amiss in the economy it is usually a safe bet that multinational enterprises (MNEs) will feature prominently in the inevitable rounding up of the usual suspects. The experience of the last decade has shown that commentators are often quick to link the activities of MNEs to contemporary economic and social ills. MNEs, so the argument often goes, cynically play off governments against each other in order to extract favourable concessions and have thereby caused a race to the bottom in environmental and social standards, depressed wages, caused unemployment and deprived states from providing adequate welfare services. Hence, the often-reached conclusion of these studies that MNEs must be at the centre of most of the world's economic and social problems<sup>1</sup>. But is it really true? Can MNEs really be accused of seeking preferential treatment and trying to shape the playing field to their advantage? Or could it be that they are instead actually more often interested in a rule-based liberal economic order, which is predictable and free from arbitrary political intervention? This study seeks to provide some answers. It is an enquiry into the nature of MNEs' economic policy preferences and their ability to influence economic policy making - both in their home countries and at the EU level. Put differently, this study seeks to analyse whether MNEs have the will, and the political clout, to promote a liberal economic order, or whether they seek to distort, or even suspend, the free formation of prices. It intends to achieve this goal by analysing and comparing the economic policy preferences and political influence of a sample of German and Swiss pharmaceutical MNEs and banks in the period from 1985 to 1995.

MNEs' economic policy preferences have often been analysed in the literature with regard

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<sup>1</sup> See for example Forrester (1996) and Glunk (1998).

to traditional, "at-the-border" trade policy issues, such as tariffs and quotas. These studies explain MNEs' preferences as the result of the extent to which they are exposed to the international economy - both through sales and cross-border production networks. The more MNEs are exposed to the international economy, so the argument goes, the less likely it is that they will seek market closing trade policies. The logic seems impeccable. After all, it would hardly make sense for a company with considerable international sales and internationalised production to support restrictions on international trade. From there, many studies swiftly predict that as the number of firms with international ties continues to increase, the free trade lobby will become so strong that policy makers will have little choice but to press on with liberalising trade policies<sup>2</sup>. Although this is certainly a very parsimonious framework of analysis with seemingly a great deal of explanatory and predictive power, it will be argued that for the purpose of this study both hypotheses are overly narrow and potentially misleading.

First, this study does not intend to limit the analysis merely to MNEs' policy preferences with regard to "at the border" trade policy issues. The goal is to examine MNEs' policy preferences with regard to the price mechanism in more general terms and while trade policies certainly affect the functioning of price competition, clearly domestic economic policies also do so as well. Moreover, even if one were to devote a study merely to trade policy issues in the 1980s and 1990s, domestic policies could not be excluded from the analysis. With the reduction of average tariffs to low, if not negligible levels (at least in the industrialised world), the obstacles to free trade are increasingly found "behind the border" in the domestic policies of states, i.e. competition policies, labour regulations, trade-related investment measures, intellectual property rights, environmental laws, safety and technical standards and other domestic practices that distort the free formation of prices at the national level and are thus difficult to reconcile with an open international economy<sup>3</sup>. Hence there is a strong case for broadening the scope of the analysis to include domestic economic policies.

However, it will be shown that in a number of cases MNEs' preferences with regard to these issues cannot be explained by the degree and nature of their internationalisation process; it will be argued that often MNEs' business focus and sectoral characteristics were more important explanatory factors. To prove this hypothesis, this study will analyse the selected 12 MNEs' *internationalisation processes*, their *business focus* and *sectoral characteristics* of the

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<sup>2</sup> See for example Milner (1988). See also footnote 31.

pharmaceutical and financial services sector. Building on this analysis, it will then examine how these three factors have interacted to shape MNEs' preferences with regard to a sample of economic policy issues that the interviewed executives identified as the most important ones facing the pharmaceutical and financial services industry during the last decade.

Second, sweeping generalisations about MNEs' political influence are hardly convincing. While it may sound plausible to argue that increasing levels of internationalisation have given firms highly visible incentives to lobby for a continued liberalisation of international trade, it does not follow automatically that MNEs preferences will always translate neatly into policy outcomes<sup>4</sup>. Different, country-specific institutions give MNEs different degrees of access to policy-making circles and hence may prove to be important intervening factors that either enhance or dilute the effectiveness with which MNEs can bring their preferences into the policy-making process. Moreover, it does not appear plausible to rely only on interests and institutions to explain policy outcomes and MNEs' political influence. While they are certainly important explanatory factors and represent a useful point of departure for the analysis, it will be shown that in many cases *changing economic and political circumstances* had an important impact on perceptions of self-interest and the institutions of the economic policy-making process, and hence on policy outcomes. The importance of circumstances for analysing MNEs' political influence will be illustrated by examining their impact on *the preferences of the government, the degree of opposition from other organised interests and the extent to which MNEs can use their internationalisation process for political leverage*. It will be shown that in many cases, circumstances relating to these three factors significantly shaped the political influence that MNEs were capable of exerting.

Certainly such a framework of analysis is unlikely to lead to a neat and parsimonious theory. However, it will at least shed some light on two important sets of issues, which the analytically more rigorous studies have difficulty explaining: first, how MNEs' preferences are formed and second, how these preferences are translated into political influence over policy outcomes. It is hoped that the gains in explanatory power and range of this study's framework of analysis will make up for the loss of parsimony. In order to illustrate the findings, this study will occasionally draw on interviews with public servants, industry and trade association executives and journalists.

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<sup>3</sup> The distinction between domestic economic policy issues and "behind the border" trade policy issues is not entirely clear-cut, not least because the latter category appears to be open-ended and very much in flux. It shall not be the task of this study to attempt to draw a boundary between the two.

The focus of the analysis will be on six German and Swiss pharmaceutical MNEs (Hoechst, Bayer, BASF and Roche, Sandoz, Ciba-Geigy) and six German and Swiss banks (Deutsche Bank, Dresdner Bank, Commerzbank and Credit Suisse, Swiss Bank Corporation, Union Bank of Switzerland) (see table 1.1). Although four of these twelve MNEs have merged since the beginning of the project – Sandoz and Ciba-Geigy to form Novartis in 1995 and Swiss Bank Corporation and Union Bank of Switzerland to form United Bank of Switzerland in 1998 – there have been no indications that the combined entities' preferences or political influence differ in any meaningful way from those of their predecessors. Hence these developments do not affect the findings of this study.

	<u>Germany</u>	<u>Switzerland</u>
Pharmaceutical MNEs	Hoechst, Bayer, BASF	Roche, Ciba-Geigy, Sandoz
Banks	Deutsche Bank, Dresdner Bank, Commerzbank	Credit Suisse, SBC, UBS

Table 1.1: The selected German and Swiss Pharmaceutical MNEs and Banks

Analysing and comparing the economic policy preferences and political influence of German and Swiss pharmaceutical MNEs and banks is relevant for a number of reasons. First, both sectors occupy a central place in their national economies. Second, MNEs from the two sectors differ considerably in their exposure to foreign markets, and third, the pharmaceutical and financial services industry are unique in the sense that due to sectoral characteristics markets in both sectors are considerably regulated – something that might encourage MNEs to pursue political strategies to tilt the playing field in their favour (see final section of this chapter). MNEs from Germany and Switzerland were chosen for the analysis since firms in

<sup>4</sup> Milner (1988) has argued that increasing exposure to international markets was likely to give firms such strong interests in an open international economy that these interests could be expected to translate into policy outcomes.

both countries are part of an institutional structure that decentralises policy-making and awards considerable influence to private actors and especially to the business community (see Chapter 4). Hence comparing the political influence of MNEs from these two countries should yield important insights about the extent to which institutions are a source of political leverage for MNEs. One might certainly object that it is a bit odd to analyse the political influence of highly internationalised firms in their home countries and not in host countries. But, arguably, it is the home country that continues to be the most important production location – even for the most international of firms. Domestic sales may pale in significance when compared to international sales, but still it has become accepted wisdom in the international business literature that the home country retains a special role and is an important source of competitive advantage. In fact, Michael Porter concluded his seminal thirteen-nation comparative study arguing that MNEs' competitive advantage significantly depends on the competitiveness of the nation in which they are headquartered<sup>5</sup>. Moreover, MNEs' political ties are likely to be strongest in their home countries. As Sally has argued,

"the home country is where MNEs are most strongly linked in historically conditioned relationships with external actors such as local, regional and governments, banks, industry associations, trade unions, suppliers and customers"<sup>6</sup>.

To be sure, it seems plausible to assume that as MNEs strengthen their market position in foreign markets they also increasingly embed themselves in the institutional structures of their host countries. It is by no means the implicit argument of this study that MNEs only play a political role in their home country. Unfortunately, however, it is beyond the manageable scope of this study to address this additional aspect.

Finally, an early word of caution seems to be in order. Clearly MNEs can influence the functioning of price competition not only through their economic policy preferences with regard to public policies but also through their business strategies. A number of studies - most notably the theory of contestable markets - have shown that incumbent firms often have substantial means at hand to pursue market-closing policies through their business strategies<sup>7</sup>. Covering this additional aspect is, however, unfortunately beyond the scope of the present

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<sup>5</sup> Porter (1990).

<sup>6</sup> Sally (1994), p. 172.

<sup>7</sup> See for example Baumol et al. (1983) and Spence (1977).

study. The focus here will be exclusively on MNEs' preferences with regard to public policies.

## **MNEs and the Study of International Political Economy**

Before reviewing the literature on MNEs' economic policy preferences and outlining the explanatory framework, this study should first be placed within a larger context since focusing on MNEs is not always common practice in the International Political Economy literature. A major strand in IPE has the state as its central unit of analysis and tends to focus on the nature of interstate bargaining to explain policy outcomes<sup>8</sup>.

One school, the realists, sees an international system of states that is essentially anarchic and places substantial constraints on the ability - and willingness - of states to reach international agreements on anything from trade to security affairs. The other school, the neo-liberal institutionalists, argues that the constraining effects of anarchy can be mitigated, even overcome, with the help of international regimes – sets of implicit or explicit principles, norms, rules and decision-making procedures around which actors' expectations converge in a given area of international relations<sup>9</sup>. By providing information and structuring state interactions, neo-liberal institutionalists argue that international regimes can overcome problems of international economic and political market failure<sup>10</sup>.

While both approaches can, at times, yield important insights, it still remains very difficult to explain contemporary international politics solely as the result of the nature of interstate bargaining. After all, it is a bit difficult to find a geopolitical strategic interest in the textile and clothing sector that could explain why trade in these two sectors is so heavily restricted. Similarly it is not convincing to explain trade policies solely by the existence of international regimes. While it is certainly convenient from an analytical point of view to rationalise trade policies *ex post* as the result of the existence or non-existence of an international regime, such an explanatory logic fails to address the important question of why states managed to co-operate in the first place to set up the regime. To be sure, there is much to learn from studying state interaction, but there is also a fundamental problem with it: to be able to study

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<sup>8</sup> See for example Gilpin (1975) and (1986), Keohane and Nye (1971) and (1977), Krasner (1982) and Strange (1984).

<sup>9</sup> See for example Krasner (1982).

analytically the interaction of states, system level-theories make ad hoc assumptions about the interests of states, thereby excluding the important process of preference formation at the national level from the analysis. There are merits in doing so, but one can nevertheless question the usefulness of this simplifying assumption since, as Susan Strange (1988) has observed, by making these starting assumptions system level theories already determine the answer to the question they seek to address.

An alternative and somewhat more plausible approach has been put forward by Ruggie<sup>11</sup>. Trying to make sense of the mix of free trade and protectionist policies in the international economy, he argued that this mix was not so much the result of the nature of interstate bargaining, but rather reflected a desire of governments to reap as many economic gains from international trade as possible while at the same time minimising structural adjustment pressures exerted by international trade on uncompetitive domestic industries. In other words, protectionist policies in his analysis are not the result of the effects of an anarchical international state system or of the absence of an international regime, but rather an attempt by governments to restrict and manipulate market forces so as to slow down the process of structural change that might otherwise have socially destabilising consequences. The central insight of Ruggie's analysis is thus that states are not only embedded in international society but also in domestic civil society and government policy is therefore also constrained by interests of individuals and groups who pressure decision-makers to pursue policies consistent with their preferences<sup>12</sup>.

Within a different context, this point has recently been taken up again in the IPE literature. As national economies have become increasingly integrated, it has become popular to speculate about a perceived decline of state authority and a growing diffusion of authority to other institutions and associations<sup>13</sup>. In fact, more recently even leading proponents of system-level explanations seem to concede that state policies are largely determined by the balance of political forces within countries<sup>14</sup>.

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<sup>10</sup> See for example Keohane (1984).

<sup>11</sup> See Ruggie (1982).

<sup>12</sup> For a similar view see Putnam (1988).

<sup>13</sup> See for example Strange (1996) and Horseman and Marshall (1994).

<sup>14</sup> See for example Keohane and Milner (1996). It should, however, be said that the trend to focus on the role of domestic actors in the policy-making process is by no means a novelty. Public choice explanations of policy outcomes have been applied to studies in International Political Economy since the 1980s. See for example Frey (1984). Particularly trade economists have used this approach for some time. See footnote 51. Similarly, the role of ideas and their impact on policy-making has featured prominently in a number of studies. See for example Hall (1989) and Goldstein and Keohane (1993).

This trend has also been echoed by developments at the theoretical level. In a recent article, Andrew Moravcsik pointed to the importance of societal ideas, interests and institutions in influencing state behaviour by shaping state preferences<sup>15</sup>. Building on this observation, he elaborated what he called a liberal theory of international relations based on the insight that state-society relations – the relationship of states to the domestic and transnational social context in which they are embedded – have a fundamental impact on state behaviour in world politics. As he put it,

“Liberal theory rests on a bottom-up view of politics in which the demands of individuals and societal groups are treated as analytically prior to politics. Political action is embedded in domestic and transnational civil society, understood as an aggregation of boundedly rational individuals with different tastes, social commitments, and resource endowments. Socially differentiated individuals define their material and ideational interests independently of politics and then advance those interests through political exchange and collective action”<sup>16</sup>.

In other words, Moravcsik rejects the claim of realists and neoliberal institutionalists that states can and should be regarded as unitary actors – black boxes – and shifts the focus of attention from the configuration of capabilities (realism) and information (neo-liberal institutionalism) to the configuration of state interests. The state, in his view, has become less of an actor, but a representative institution constantly subject to capture and recapture, construction and reconstruction by coalitions of social actors<sup>17</sup>. While one does not necessarily have to agree with all of the above conclusions – i.e. that states have become virtually powerless – one can still accept a point common to all of them: the importance of organised domestic groups for policy-making. It is this assumption that provides the starting point for this study. It is an investigation into the public policy preferences and the political influence of one particular domestic actor: the multinational enterprise (MNE), which can be defined as an economic unit that operates across national boundaries, producing in at least one other foreign country as well as in its home market<sup>18</sup>.

MNEs were selected for the analysis for a number of reasons. First, they are important economic actors and one of the main conduits through which the globalisation of business

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<sup>15</sup> See Moravcsik (1997).

<sup>16</sup> Ibid., p. 517. For a similar view see also Milner (1992) and (1997).

<sup>17</sup> Moravcsik (1997), p. 517.

takes place. Despite the fact that multinationals number only in the thousands, they account for about half the world's trade in goods, with about two thirds of their trade taking place between related units of the same enterprise<sup>19</sup>. Their significance is, however, not only confined to international trade. In 1997, it was estimated that MNEs' sales through their foreign affiliates totalled \$9.7 trillion - an amount considerably larger than the size of world's total exports (see table 1.2).

Year	Sales	Exports	Ratio of sales to exports
1984	2.581	1.632	158.2%
1987	3.492	1.941	179.9%
1990	5.089	2.797	181.9%
1993	6.022	3.175	189.7%
1997	9.728	6.710	145%

Table 1. 2: World Sales of MNEs' Foreign Affiliates and World Exports, 1984 -1993 (US\$ bn).

Source: Adapted from *World Investment Report* (1995), p. 37. See also UNCTAD, FDI-TNC data base E. 99. II. D.3, table 1.2, p. 9.

Moreover, MNEs have been growing at a rapid rate during the last decades. One manifestation of their rapid growth has been the persistent increase in the flows of foreign direct investment (FDI) around the world (see table 1.3). In fact, between 1980 and 1995 alone, according to United Nations data, the stock of FDI around the world increased over six times, to \$3.2 trillion<sup>20</sup>. Other measures also reflect the rapid growth of multinational enterprises. One source, for instance, estimates that the number of jobs in the world's MNEs increased from 40 million in 1975 to 73 million in 1992<sup>21</sup>. Finally, MNEs also play a key role in disseminating technology around the globe. The UN's 1997 *World Investment Report*

<sup>18</sup> For definitions of the MNE and international production, see Rugman (1986), p. 7 and Dunning (1988), p. 1.

<sup>19</sup> See Lipsey (1995), pp. 8.

<sup>20</sup> See *World Investment Report* (1996), p. 239.

<sup>21</sup> See *World Investment Report* (1994), p. 175.

estimated that 70 per cent of all international royalties on technology involve payments between parent firms and their foreign affiliates<sup>22</sup>.

	Developed Countries		Developing Countries		Central and Eastern Europe	
Year	Inflows	Outflows	Inflows	Outflows	Inflows	Outflows
1983-87	58.7	72.6	18.3	4.2	0.02	0.01
1988-92	139.1	193.3	36.8	15.2	1.36	0.04
1990	169.8	225.5	33.7	17.8	0.30	0.04
1991	114.0	201.9	41.3	8.9	2.45	0.04
1992	114.0	181.4	50.4	21.0	3.77	0.10
1993	129.3	192.4	73.1	33.0	5.59	0.20
1994	132.8	190.9	87.0	38.6	5.89	0.55
1995	203.2	270.5	99.7	47.0	12.08	0.30

Table 1.3: Foreign Direct Investment Inflows and Outflows, 1983-1995 (US\$ bn).

Source: *World Investment Report* (1996), p. 4

Second, due to the size and the scale of their business operations, MNEs have emerged as important political actors<sup>23</sup>. While certainly all large enterprises – as big employers, producers, suppliers and taxpayers – cannot avoid making political waves, their actions take on a special dimension when they are also multinational. In contrast to companies whose facilities are located in a single country and have no alternative but to comply with that country's laws and social norms, MNEs can move production to other countries<sup>24</sup>. In other words, their scanning horizon will ordinarily be regional or global, not only national. If need be, therefore, the multinational may shift from local production to imports, or from imports to

<sup>22</sup> Quoted in *The Economist* School's Brief on Globalisation, Nov. 22 1997.

<sup>23</sup> One of the first major studies to puzzle over the political and economic consequences of the growing number of MNEs was Vernon (1971).

<sup>24</sup> Vernon (1998, p. 22) has noted that MNEs commonly see the world as a chessboard on which they are conducting a wide-ranging campaign. The chessboard's squares are nation-states, and an enterprise can consider entering any one of them by a number of different means - by trading with independent firms in the country, by developing alliances with enterprises already operating in the country, or by establishing a subsidiary of its own in the country.

local production<sup>25</sup>. Conceivably, this flexibility may give MNEs disproportionate political influence compared with other domestic actors. In fact, by comparison with earlier decades, the 1980s and 1990s have been distinctive for the efforts that governments have made to bring foreign-owned enterprises onto their national turf. A UN agency, keeping track of the changes that governments have made in their rules regarding FDI, identified hundreds of such changes between 1991 and 1995 involving many different countries, and found that practically all were aimed at presenting a friendlier face to foreign firms<sup>26</sup>. Tax reductions or exemptions of various kinds have been especially common. A UN survey covering the early 1990s identified 103 countries, situated in all areas of the world and representing all stages of development, whose national governments were offering such incentives in various forms (see table 1.4). Apart from the incentives listed in the table, these countries offered a variety of lesser fiscal concessions, including accelerated depreciation on their depictable assets and exemptions from national sales taxes<sup>27</sup>.

Finally, the emergence of MNEs as political actors can also be traced in the international business literature<sup>28</sup>. John Dunning, for example, has suggested that focusing on the interaction of governments and MNEs may provide the basis for one of the next advances in the theory of international production<sup>29</sup>. In similar vein, Grosse and Behrman have argued elsewhere that MNE-government bargaining should be placed at the centre of international business scholarship<sup>30</sup>. In short, there seems to be a good case for devoting an analysis to the preferences and political influence of MNEs.

However, a final word of caution seems to be in order. This study does not intend to elaborate a theory of policy-making based on the preferences of domestic actors. An appreciation of the problems surrounding interstate bargaining continues to be important for a well-rounded analysis. Despite strong domestic support for international agreements, political leaders may often still find it impossible to strike a deal – be it either for reasons resulting from the dynamics of the international state system or because each party to the negotiation wants to secure a disproportionate share of the joint gains for its country. Hence

		Developing	Developed	Central and	
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<sup>25</sup> See for example Rangan (1998).

<sup>26</sup> See World Investment Report (1996), p. 132

<sup>27</sup> See Vernon (1998), p. 32.

<sup>28</sup> To be sure, MNEs as political actors have also featured in the Marxist/dependency theory literature from the 1960s. See for example Hymer (1978).

<sup>29</sup> See Dunning (1992), p. 135.

<sup>30</sup> See Grosse and Behrman (1990) and (1992).

		Countries	Countries	E. Europe	Total
Number of Countries		52	26	25	103
Incentives:	Reduction in Income Tax	43	20	20	83
	Tax Holiday	37	11	19	67
	Exemption from import duties	29	11	13	63
	Refunding of import duties For exports	28	9	12	49

Table 1.4: Selected Fiscal Incentives Offered Foreign Investors in the early 1990s.

*Source:* Adapted from United Nations, *Incentives and Foreign Direct Investment*

(New York: United Nations, 1996), Table III.2, adapted from Vernon (1998), p. 32.

this study should by no means be seen as an attempt to outline a general theory of policy-making based on the preferences of one particular domestic actor. It is merely argued here that system- and domestic-level explanations are not mutually exclusive and that the explanatory power of the former could certainly be enhanced by a better understanding of the policy preference formation at the domestic level. After all, one should know the preferences of the states involved before one can study inter-state bargaining.

Having distinguished between system- and domestic-level explanations of policy outcomes – and having placed this study into the second category – this study will now review the existing literature on MNEs and economic policy. Building on this review, the following section will then outline the argument and framework of this study.

## MNEs and Economic Policy

For the purpose of this study – analysing MNEs' economic policy preferences and their political influence – three sets of questions are of relevance: first, how can one explain MNEs' policy preferences? Second, what kind of different preferences are there and how can one analytically distinguish between them? And third, how can one analyse MNEs' political influence over policy outcomes? All three questions have featured in a number of studies, albeit more or less in isolation from each other.

As has already been mentioned, MNEs' economic policy preferences are often analysed within the narrower category of trade policy and are explained as the result of the nature and extent of MNEs' exposure to the international economy. In its crudest form, the argument is that high levels of dependence on international markets will create free trade preferences among MNEs<sup>31</sup>. Since tariffs and other restrictions of international trade only complicate and disrupt MNEs' international business activities, it is only rational for firms to be in favour of open markets. However, it is also well recognised in the literature that this straightforward formulation is not always tenable since it rests on a rather narrow conception of MNEs' international business activities; in most of the quoted studies, export dependence is the only link of firms to the international economy. Clearly, however, there is also another important link: intra-firm trade resulting from cross-border production networks. As has been pointed out in the previous section, two thirds of MNEs' trade has during the last years been taking place between related units of the same enterprise. In fact, when other studies incorporated MNEs' internal organisational structure as an additional explanatory variable, the picture that emerged became more blurred and cast doubt on the hypothesis that there was a direct and straightforward link between the foreign operations of firms and their free trade preferences.<sup>32</sup> For example, it became apparent that for MNEs without integrated international production networks it may well be "rational" to be selectively protectionist in their policy preferences. If a firm has production facilities in a protected market, then trade barriers can constitute a convenient edge over other foreign rivals. Also, the nature of free trade preferences resulting from export dependence is likely to be different from the nature of free trade preferences resulting from firms' organisational structures. Firms that are dependent on exports can, no doubt, be expected to resist protectionist policies. These firms, however, will primarily be interested in opening markets abroad and only secondarily in opening the home market. Firms

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<sup>31</sup> See for example Baldwin (1982), Baldwin (1986), Aggarwal, Keohane and Yoffie (1987), Ray (1981), Lavergne (1983).

<sup>32</sup> See for example Helleiner (1979), Lipson (1982), Bhagwati (1991), p. 330.

with integrated international production networks, on the other hand, are likely to favour equally a further opening of both the home market and markets abroad<sup>33</sup>.

One study that incorporated all these caveats is Helen Milner's "Resisting Protectionism"<sup>34</sup>. Building on the insights of earlier studies, her explanation of MNE's trade policy preferences focuses on two variables linking firms to the international economy: export dependence and intra-firm trade resulting from cross-border production networks. Each of these is explicitly recognised as constituting a different aspect of a firm's integration into the world economy, and hence each is viewed as giving rise to a distinct set of preferences relating to trade policy<sup>35</sup>. By distinguishing between four different types of firms - firms that are lacking international ties and are primarily oriented to the domestic market, firms with extended exports but little multinationality, firms with significant export dependence and sizeable, integrated multinational operations, and firms with little export activity and little integrated international operations but with substantial foreign production to service host markets<sup>36</sup> - her analytical framework can account for much of the complexity surrounding the trade policy preferences of MNEs that is missing in other studies. Her conclusions, however, are similar to the ones of the previous studies: firms with more extensive exports and multinationality should be less likely to demand protection, and more likely to resist it actively, even when facing serious import competition. The more important foreign operations are for firms, the less protectionist they will be, since demands for protection may spark retaliation abroad, which will in turn hurt their own foreign operations. In short, her argument is that there is a strong positive correlation between the degree of firms' internationalisation and the intensity of their free trade preferences<sup>37</sup>.

With regard to the second question – how one can analytically distinguish between different types of preferences – the literature has identified a broad range of possibilities. On one end of the spectrum is Anne Krueger's view of the firm as a mere rent-seeker. In her article "The Political Economy of the Rent-Seeking Society"<sup>38</sup>, she analysed one specific type

of firm political behaviour: rent-seeking triggered by quantitative restrictions on international trade, under which the right to import depends on the possession of government licenses. She argued that under such restrictions, firms could be expected to enter the political arena to

<sup>33</sup> See Milner (1988), p. 25.

<sup>34</sup> Milner (1988).

<sup>35</sup> Ibid., p.18.

<sup>36</sup> Ibid., pp. 24f.

<sup>37</sup> Ibid., pp. 18, 19, 222.

lobby government officials for a favourable allocation of import and export licenses and the windfall gains associated with the ownership of them. In other words, in her framework of analysis, firms' political strategies were confined to price mechanism suspending rent-seeking activities and governments were the only other domestic actors with which MNEs could be expected to interact.

On the other end of the spectrum, one can point to the already described free trade promoting MNEs of Milner's analysis, which, due to their exposure to the international economy, have a strong interest in open markets. A similar view can be found in the corporatist and neo-corporatist literature, which also, by and large, argues that MNEs' political efforts are aimed at keeping markets open<sup>39</sup>. Moreover, in the cases analysed in this strand of the IPE literature, firms' political activities are not merely confined to lobbying activities but rather encompass a whole range of activities. In fact, firms actively - and legitimately - participate in the economic policy-making process, almost as joint decision-makers, and thereby interact not only with governments but also with a whole range of other domestic actors over a large number of issues.

In between those two polar ends one can then find a number of studies suggesting a somewhat more differentiated nature of MNEs' political strategies. Although undoubtedly being closer to Krueger's framework of analysis, these studies show that lobbying for preferential treatment does not necessarily entail the kind of suspension of the price mechanism that Krueger assumes. Firms may also choose to work through the price mechanism, while at the same time trying to distort it. In fact, Bhagwati and Srinivasan have argued that it was not sufficient to be merely concerned with lobbying activities triggered by different government licensing practices and that by focusing exclusively on quantity restrictions and the rents thereon, Krueger's model excluded other sources of lobbying activities from the analysis, such as for example activities triggered by price distortion and distortion-triggering activities<sup>40</sup>. In their article, they paid particular attention to one such price distortion triggered activity, which they labelled revenue seeking - a situation in which firms lobby for a slice of tariff revenues resulting from the adoption of protective tariffs<sup>41</sup>. Baldwin has noted that this case was conceptually somewhat different from the rent-seeking analysed by Krueger: when quantitative restrictions are applied to international trade, governments

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<sup>38</sup> Krueger (1974).

<sup>39</sup> See for example Schmitter (1982), Katzenstein (1984) and (1990), Streeck (1992). For the distinctive features of neo or meso corporatism see Cawson (1985) and Grant (1985). See also footnote 58.

<sup>40</sup> Bhagwati and Srinivasan (1980), p.1000.

<sup>41</sup> Ibid.

must devise a system to allocate the rights to import or export among producers, which amounts to a de facto suspension of the price mechanism. As a result, competition will shift from the economic to the political sphere, as producers will compete for export and import licenses. Under a tariff arrangement, however, the allocation of imports and exports is still carried out via the price mechanism - however distorted - with the tariff revenue usually going automatically into the public treasury in the same way as any tax revenue<sup>42</sup>.

Finally, firms cannot only be expected to respond to a distorted environment, but they are also likely to try to shape it to their advantage, thereby triggering distortions. The obvious example is tariff seeking where producer lobbies seek protectionist trade tariffs<sup>43</sup>.

All of these different types of firm lobbying activities have been neatly grouped into a general concept by Bhagwati, which he dubbed directly unproductive, profit-seeking (DUP) activities<sup>44</sup>. He pointed out that such diverse activities as lobbying for protection, competing for a share of industrial output or import licenses or inducing legislatures to enact monopolistic barriers to entry have the unifying characteristic that they:

“represent ways of making a profit by undertaking activities which are directly unproductive; that is, they yield pecuniary returns but do not produce goods or services that enter a utility function directly or indirectly via increased production or availability to the economy of goods that enter a utility function... for example, tariff seeking or premium seeking for given import licenses are all privately profitable activities. However, their direct output is simply zero in terms of the flow of goods and services entering a conventional utility function”<sup>45</sup>.

Taken together, the reviewed literature is quite unequivocal in two ways. First, MNEs trade policy preferences can be explained by the degree and nature of their exposure to the international economy, and second, MNEs preferences may promote, suspend or distort the price mechanism. With regard to the third question – how to account for firms’ influence over policy outcomes – the literature is, however, split into two camps. One camp focuses on

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<sup>42</sup> Baldwin (1988), p. 131.

<sup>43</sup> See for example Brook and Magee (1978), Bhagwati (1980), Feenstra and Bhagwati (1982), Findlay and Wellisz (1982) and Bhagwati (1991).

<sup>44</sup> See Bhagwati (1982).

<sup>45</sup> Ibid., pp. 999-1000.

interests and incentives – the rational choice literature – and the other on institutions – the corporatist and neo-corporatist literature<sup>46</sup>.

The rational choice literature is essentially an application of economic methods and concepts to politics; it explains policy outcomes in terms of individuals' (or groups') narrowly defined incentives and interests<sup>47</sup>. The approach employs the psychological assumptions of homo oeconomicus - the rational utility-maximising actor, who chooses optimally with given means and ends and given constraints under conditions of stable equilibrium in perfectly competitive markets<sup>48</sup>. The basic economic model of politics that has been developed - commonly referred to as public choice theory - models the political process as an implicit market with demanders (voters or interest groups) of government policies exchanging votes for desired policies. Government (politicians and bureaucrats) will supply policies that maximise the governing party's prospects of re-election<sup>49</sup>. Decision-making is perfectly rational, and there are no transaction and information costs. Moreover, implicit in the public choice approach is the view that the intent of most government policies is not to advance the common good, but rather to construct minimum winning coalitions, often through redistributional policies<sup>50</sup>.

In fact, this theory of political economy is often used to explain protectionist policies: those who stand to gain from free trade, especially consumers, have little incentive to organise and become politically active since the benefits of free trade are widely spread and diffuse. However, the costs from free trade to import-competing industries are visible and concentrated. Therefore, the latter have an incentive to organise collective action and participate in the political process<sup>51</sup>. An interesting variation of this argument is found in Milner's analysis. Employing the same logic, but giving it a new twist, she argues that high exposure to the international economy makes the otherwise diffuse gains from free trade highly visible to producers who thus have strong incentives to organise collective action and lobby for free trade.

<sup>46</sup> Baldwin has identified various other models of the policy process which centre on other factors: long-run pursuit of self-interest by economic agents and political actors, autonomous behaviour by public officials who are not simply intermediaries acting on the wishes of the electorate or some part of it, and altruism on the part of public and private actors. See Baldwin (1985), Chapter 1. The difficulty with these models is that their assumptions are so vague as to be largely untestable and are likely to provide a positive rationalisation for almost any conceivable set of policies. See Trebilcock and Howse (1999), p. 17.

<sup>47</sup> In fact, a number of scholars have defined political economy as no more than the application of economic methods to politics. See for example Frey (1984).

<sup>48</sup> Mueller (1982) has argued that the basic behavioural postulate of public choice, as for economics, is that man is an egoistic, rational, choice-maximiser.

<sup>49</sup> See Trebilcock and Howse (1999), p. 15.

<sup>50</sup> *Ibid.*

While rational choice theories are certainly capable of offering parsimonious explanations of complex realities, there are, however, a number of problems with this approach. The first problem centres on the objectives of actors and rational choice's definition of rationality. As Herbert Simon, among others, has convincingly argued, rationality is bounded - it depends on the information that actors have about the world around them<sup>52</sup>. In fact, cognitive psychology has shown convincingly that people frame information in ways that depart significantly from ideal typical rationality<sup>53</sup>. Within this context, Goldstein and Keohane have argued that ideas, defined as beliefs held by individuals, help to explain political outcomes, since such ideas help to clarify principles and conceptions of causal relationships<sup>54</sup>. It is, however, not only ideas that affect perceptions of self-interest. Henderson, for example, has argued that in addition to ideas, particular allowance has to be for the influence of events. Trying to explain the liberalisation measures in a large number of countries during the 1980s and 1990s, he has argued that

“in causing attitudes to change, it is the influence of events – of new developments, and the constructions placed on them – that has often been the main determining factor, particularly when those events were unforeseen and posed problems”<sup>55</sup>.

In other words, by excluding factors relating to actors' perceptions of a situation from the analysis, rational choice explanations severely limit their explanatory and predictive power. Second, by focusing only on interests and incentives, rational choice explanations have problems to explain policy outcomes where the antagonists had equally strong interests and incentives. In fact, Destler and Odell have argued that the weakness of the public choice model is its simplistic assumption that, on the one hand, producer interests were uniform and easily organised and on the other, consumers were politically disabled<sup>56</sup>. Moreover, while it is true that consumers may face information costs and other transaction costs that make effective group mobilisation difficult, as individuals they still possess votes, which constitute a resource that firms, whatever their other political resources, do not possess. In other words, the

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<sup>51</sup> See for example Downs (1957) and Olson (1965).

<sup>52</sup> See Simon (1982).

<sup>53</sup> See for example Kahneman and Tversky (1984) and Tversky and Kahneman (1981).

<sup>54</sup> See Goldstein and Keohane (1993).

<sup>55</sup> Henderson (1998), p. 92.

<sup>56</sup> See Destler and Odell (1987).

determinants of the political rate of exchange between various political currencies (for example, votes and financial resources) are not well addressed in the public choice model<sup>57</sup>.

The corporatist and neo-corporatist literature, on the other hand, avoid some of these shortcomings. These approaches explain policy outcomes in terms of institutions that link the major domestic actors (i.e. industry associations, labour unions and other organised interest groups) and structure policy-making in certain ways, thereby awarding different incentives and degrees of power to domestic actors<sup>58</sup>. In other words, institutions – the formal and informal rules of the game<sup>59</sup> – are recognised as crucial intervening variables that create information, define the range of options that are contemplated by the actors and shape political influence in the economic policy-making process<sup>60</sup>.

However, this explanatory approach is also not problem-free. Most importantly, like public choice theories, it is overly narrow. Economic developments, changing political priorities, new interest groups and other external factors can all change the circumstances under which policy-making is taking place, and by focusing the analysis strictly on institutions, corporatist explanations of policy outcomes are unable to account for the impact of such developments. Second, and this is less a conceptual problem than an empirical shortcoming, the focus of most corporatist and neo-corporatist studies has not been on individual MNEs but on industry associations. This appears, however, not to be sufficient. Viewing an industry as some unified whole leads one to overlook differences between individual MNEs. After all, the MNEs within an industry are the real actors. They are the ones developing ties to the international economy, interacting with other domestic actors and voicing demands. As Sally has argued,

"the MNE is not only the key economic and commercial actor in structures of international production, but it is also implanted in the institutional arrangements of nation states, as well as sub-national and supra-national regions. Within these national and regional political economies it is at the vortex of myriad relationships with constellations of

<sup>57</sup> See Trebilcock and Howse (1999), p. 16.

<sup>58</sup> See for example Katzenstein (1977), (1984), (1985) and (1989), Streeck (1988), Zysman (1983) and Wilks and Wright (1987). Pryor (1988, p. 317) has defined corporatism as "a type of organised or coordinated capitalism where power to make important economic policies is transferred from the parliament and government to semi-private organisations". More recently Woldendorp (1997, pp.49-50) has noted in similar vein that "the term neo-corporatism is used to denote any form of cooperation between the government and the relevant socio-economic interest groups of employers' associations and trade unions, aimed at forging a consensus over the formulation and implementation of socio-economic government policies...".

<sup>59</sup> See North (1990).

<sup>60</sup> Peter Hall, for example has argued that institutions are structural inasmuch as they set parameters for the day-to-day processes that go on within them, leaving individuals and groups with a certain range of decisional manoeuvre. See Hall (1986), Chapter 1.

external actors - suppliers and clients, but also different tiers of government, financial institutions, trade unions, industry associations, research institutes and universities“<sup>61</sup>.

## **The Argument of the Study**

The reviewed literature is, no doubt, helpful in a number of ways for constructing an explanatory framework to analyse the selected MNEs' economic policy preferences and their political influence. First, Milner's study identifies an important source of MNEs trade policy preferences: the degree and nature of MNEs' exposure to the international economy. Second, for the purpose of analytical clarity, one can identify three different types of preferences in the literature: suspension, distortion and promotion of the price mechanism. And third, the rational choice and corporatist literature offer two different ways of explaining policy outcomes: one by emphasising utility maximisation and the other by drawing attention to the institutions that link MNEs to other domestic actors. Nevertheless, there appear to be important gaps in the literature that become apparent when one tries to pull the various threads together in order to explain the economic policy preferences and political influence of German and Swiss pharmaceutical MNEs and banks.

First, the scope of economic policy preferences that can be explained by the degree and nature of MNEs' internationalisation process appears to be limited to "at-the-border" trade policy issues. If one, however, seeks to analyse whether MNEs policy preferences are price mechanism promoting, distorting or suspending, it is not sufficient to be merely concerned with trade policies. Clearly domestic economic policies also have an impact on the functioning of the price mechanism. For example, health care policies and biotechnology regulations in the pharmaceutical sector clearly influence supply and demand conditions. Similarly, capital market regulations in the banking sector significantly affect the functioning of financial markets. Moreover, as successive GATT rounds have succeeded in reducing tariffs – in the developed countries to almost negligible levels – obstacles to freer trade have increasingly shifted to policy issues that are found “behind the border” in the domestic policies of states<sup>62</sup>. As was mentioned earlier, labour and technical standards, competition policies, environmental and safety regulations, protection of intellectual property, investment

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<sup>61</sup> Sally (1994), p. 162.

measures, procurement policies – all policies and practices that were once considered to be purely domestic matters have begun to feature prominently on international trade agendas. In fact, the Uruguay Round of GATT negotiations reflected these changes in the nature of trade and trade barriers. The treaty to seal the Round enormously increased the scope of trade rules: the WTO not only took over the old GATT, which dealt with trade in goods, but also took on new agreements on services, investment, intellectual property, technical barriers to trade, sanitary measures and plant health. Since the end of the Uruguay Round, agreements have been reached on trade in telecommunications services<sup>63</sup>, financial services and information technology. Consequently, even if one were just concerned with an analysis of MNEs' trade policy preferences during the 1980s and 1990s, it would be somewhat anachronistic and incomplete to confine the analysis merely to tariffs and quotas.

However, it will be shown that if one broadens the scope of the analysis to include domestic economic policies, one also has to broaden the explanatory framework, since MNEs' *extent and nature of internationalisation* do not always plausibly explain their policy preferences with regard to domestic policy issues. Instead, MNEs' *business focus* and *sectoral characteristics* are in many cases important explanatory factors. In order to prove this hypothesis, Chapter 2 will analyse the extent and nature of the 12 MNEs' internationalisation processes and examine their business focus. Chapter 3 will then analyse how these two factors have interacted with sectoral characteristics to shape MNEs' economic policy preferences with regard to the selected policy issues (see figure 1.1).

This study, however, is not only about MNEs' preferences but also about their political influence. It is, in a sense, a two-step procedure. First, it will determine how preferences are formed, and then, second, it will analyse how preferences translate into political influence. As has been pointed out earlier, the literature offers two principal ways of explaining policy outcomes: a rational choice and an institutional approach. It was argued that while both

MNEs' Internationalisation Process

<sup>62</sup> See for example Lawrence (1995), Seade (1995) and Schott (1996).

<sup>63</sup> The basic telecommunications services agreement, for example included a commitment - made by most of the 69 countries that signed the deal - that telecommunications regulators will be independent of suppliers and government ministries. As a result, the agreement subsumed parts of domestic competition policy into world trade rules.

MNEs' Economic Policy Preferences

Sectoral Characteristics

Figure 1.1: Explanatory Framework for MNEs' Economic Policy Preferences

approaches can yield valuable insights, both of them are not entirely problem-free. Particularly problematic from the perspective of this study is their neglect of the circumstances under which policy-making is taking place. By excluding external events from the analysis such as, for example, a depression, the overthrow of a government or factors relating to the business cycle, both approaches cannot explain how changing circumstances affect perceptions of self-interest and institutions. However, it appears plausible to assume that changing circumstances can have an important impact on policy outcomes. Goldstein, for example, has argued that contemporary variations in the treatment of industries in U.S trade policy are not fully explained by variations in their economic positions or political resources. Different laws apply to antidumping and escape-clause issues, and, according to her, we can understand these laws only by exploring the circumstances under which they were first enacted<sup>64</sup>. In similar vein - and as noted above - Henderson has argued that the liberalisation measures that have been enacted in a large number of countries during the last 20 years cannot primarily be explained by the activities of organised interests, but rather can be largely attributed to the combined impact of events and ideas on the prevailing climate of opinion. In his view, in many if not most of the reforming countries, the main single impulse to change has been reactive, rather than (or as well as) affirmative: reforms have resulted, not so much from an endorsement of liberal principles as such, but rather from perceptions of failure, malfunctioning or ineffectiveness within the system, perceptions which themselves arose from events and what were seen as the lessons to be drawn from them<sup>65</sup>.

In view of these findings, it seems clear that an explanatory framework that seeks to explain policy outcomes and the influence of MNEs over them, should include an analysis of

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<sup>64</sup> See Goldstein (1993).

<sup>65</sup> See Henderson (1998), pp. 91ff.

the circumstances under which policy-making took place. This does by means imply that changing circumstances rather than interests (as interpreted by human beings) move the world. Certainly the rationalist, or for that matter, the institutional approach are often valuable starting points for an analysis. However, the existence of empirical anomalies suggests that circumstances as well as interests and institutions have causal weight in explanations of policy outcomes. Hence this study will supplement public choice and institutional explanations of MNEs political influence with an analysis of the circumstances under which policy-making took place in order to unravel the various interacting causal relationships involved, and to identify the one that seems to bear most weight (see figure 1.2). Particular emphasis will be on the impact of changing circumstances on the *preferences of the government*, the *extent of opposition from other organised interests* and the *degree to which MNEs' internationalisation process was a source of political leverage*.

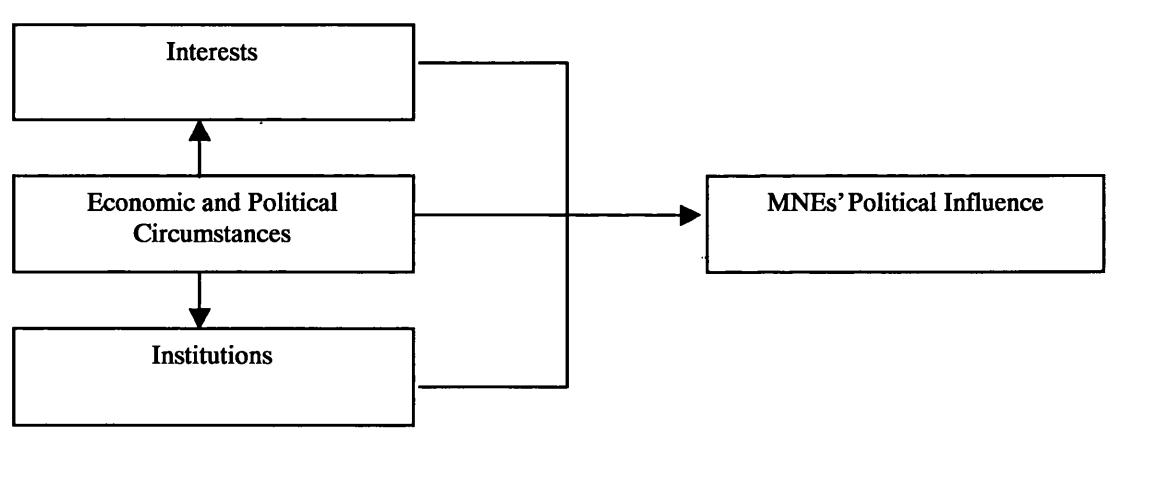


Figure 1.2: Explanatory Framework for MNEs' Political Influence

It might seem somewhat anachronistic in an age of globalisation to assign so explicitly explanatory power to the preferences of governments. Conventional wisdom often has it that markets have become all-powerful and states have been condemned to eternal retreat. Certainly, markets have been in steady assent during the last decades: in the half century following the end of World War II, political leaders around the world have been engaged in a nonstop process of negotiating for the reduction of tariffs and other protective barriers that surrounded their national economies. This has led to an increasing integration of national economies, a process that greatly accelerated during the 1980s and 1990s through the growing

importance of intra-industry trade, inter- and intra-firm trade, the increasing integration of developing and newly industrialising countries in the global economy, global capital markets and technological changes (see next section). Moreover, since the 1980s governments in virtually all industrialised countries have been shifting their roles as economic actors in their national economies by reducing their activities as owners and managers of factories, banks and public utilities, and giving more rein to the private sector in the operation of productive facilities. In John Dunning's words, "governments have been shifting their activities from an intrusive operational role in their national economies to a role directed at the systemic aspects of those economies"<sup>66</sup>. While these shifts have certainly varied substantially in detail from one country to the next, the overriding shift has nevertheless been unmistakeable<sup>67</sup>.

However, there has also been a countervailing trend during the same period. While governments around the world seem to have accepted the desirability of assigning a greater role to market forces, they have also lamented the apparent loss of control over the economy and have in the process tried to devise other ways of salvaging some elements of their former control. A common consequence has been that the governmental sector of rich industrialised economies has grown persistently since the end of World War II (see table 1.5). In a recent survey of the state's role in the economy, *The Economist* concluded that far from being dead, big government is flourishing mightily<sup>68</sup>. In fact, a review of economic developments in Germany and Switzerland during the last decades will show strongly increased government activities. It will be pointed out that as a structurally changing world economy began to threaten domestic employment and wage levels, governments in both Germany and Switzerland became more keen to micromanage economic outcomes in order to engineer socially desirable market results<sup>69</sup>. These developments suggest that MNEs' political influence is likely to be conditioned by the degree to which their preferences are congruent with those of governments.

A second factor shaping the political influence of MNEs, which is likely to be conditioned by circumstances relating to a specific policy area, is the degree of opposition from other organised groups. The process of globalisation appears to have been particularly significant in this context. Vernon has argued that the basic adjustments demanded by globalisation cannot

<sup>66</sup> Dunning (1997), p. 8.

<sup>67</sup> See Vernon (1998), p.178.

<sup>68</sup> See "The Future of the State: A Survey of the World Economy", *The Economist*, Sept. 20 1997.

<sup>69</sup> Indeed, the survey in *The Economist* noted that in most Western countries, the most expensive government programmes were nowadays the middle class entitlement programmes, which were noted intended to provide a safety net for the poor but to deliver elaborate services to all (i.e. pensions, health care and plethora of transfers and subsidies). *Ibid.*

take place without political struggle since too many interests in the nation states see the economic risks and costs of the adjustments involved as unfairly distributed and deeply threatening. In his view, MNEs are especially vulnerable in this debate since they are so closely associated with the forces of globalisation<sup>70</sup>. This observation fits in well with this analysis: Chapter 4 will point out that over the last decade interest groups proliferated in both Germany and Switzerland that viewed the activities of MNEs with great scepticism or even downright hostility. This development induced an element of uncertainty into traditionally close government-industry relationships in both countries and made policy outcomes less predictable from the viewpoint of the business community.

A final explanatory factor of MNEs' political influence is their internationalisation process. As has been pointed out earlier, MNEs have the option to shift business activities between various production locations – something that might give them additional political leverage and might enhance their bargaining power vis-à-vis other actors. It has, for example, often been pointed out that the threat to move production abroad was likely to discourage workers from demanding wage rises<sup>71</sup>. However, while the threat to shift production abroad is certainly real in some cases, it seems nevertheless not plausible to assume that it is equally real across different sectors and policy areas. For example, moving production abroad can in some cases involve substantial sunk costs and thus discourage MNEs from further internationalising their production networks. Moreover, not all policy issues with which MNEs are confronted relate to production conditions. Many issues are likely to concern market conditions (e.g. health care regulations in the pharmaceutical sector) and here the "threat" to shift production abroad is hardly credible. After all, it would hardly make sense for MNEs to pull out of a market in protest against certain market regulations. As a result of these complexities, the extent to which internationalisation is a source of political influence for MNEs is likely to vary across different sectors and policy issues.

Country	1960	1980	1990	1996
Austria	35.7%	48.1%	48.6%	51.7%
Belgium	30.3	58.6	54.8	54.3

<sup>70</sup> Ibid., p.219.

<sup>71</sup> See for example Vernon (1998), p. 175.

Canada	28.6	38.8	46.0	44.7
France	34.6	46.1	49.8	54.5
Germany	32.4	47.9	45.1	49.0
Italy	30.1	41.9	53.2	52.9
Japan	17.5	32.0	31.7	36.2
Netherland	33.7	55.2	54.0	49.9
Norway	29.9	37.5	53.8	45.5
Spain	18.8	32.2	42.0	43.3
Sweden	31.0	60.1	59.1	64.7
Switzerland	17.2	32.8	33.5	37.6
Britain	32.2	43.0	39.9	41.9
Austria	35.7	48.1	48.6	51.7
United States	27.0	31.8	33.3	33.3
Australia	21.2	31.6	34.7	36.6
Ireland	28.0	48.9	41.2	37.6
New Zealand	26.9	38.1	41.3	47.1
Average	27.9	42.6	44.8	45.9

Table 1.5: Government Spending as Percent of Gross National Product.

*Source:* Adapted from *The Economist*, September 20, 1997, p. 58; based on IMF data.

In short, it is argued here that the explanatory power of interest-based and institutions-based explanations can be significantly enhanced by supplementing both approaches with an analysis of the specific circumstances under which policy-making was taking place. The objective is not to disprove interest- or institutions-based explanations, but rather to go beyond them and to analyse how changing circumstances interact with institutions and interests to shape the political influence of MNEs.

In order to prepare the ground for such an analysis, Chapter 4 will map out the institutions of the German and Swiss economic policy-making process and provide an overview of the circumstances under which policy-making was taking place during last decade. Chapters 5 (pharmaceutical MNEs) and 6 (banks) will then focus on a selection of policy issues and

analyse the extent to which MNEs' political influence can be explained by institutions, interests and the impact of circumstances.

Although this is a study about the political influence of MNEs in their home countries, the analysis would be somewhat incomplete without mentioning the European level of policy-making. Chapters 5 and 6 will show that over the last decade an increasing extent of decision-making competence has been shifted to European institutions and that Switzerland, despite not being a member of the EU, has also been affected by EU policies. Hence Chapter 7 will analyse the 12 MNEs' political strategies at the EU level.

Before a justification for the empirical focus is advanced, a final caveat relating to the definition of political power needs to be addressed. While there is a large literature on the subject, there seems to be remarkably little consensus about semantics. As Susan Strange has pointed out,

“on the semantics, political theorists have argued endlessly about words – about whether power is a large generic term, which encompasses everything from direct coercion by violent means to the influence exerted through the subtle arts of persuasion; or whether the word should be more narrowly defined so that power is distinguished from authority or influence and is only present when those on whom power is exerted have little or no option but to give in – when, in the Mafioso's words, they are given an offer they can't refuse”<sup>72</sup>.

Although there are certainly circumstances when such discussions are necessary, this study is foremost an empirical analysis and hence does not intend to get involved in such theoretical debates. Power or political influence in this study is simply the ability of MNEs to affect policy outcomes so that their preferences take precedence over the preferences of other domestic actors.

## Empirical Focus

Finally, a number of issues relating to the empirical focus of this study need to be clarified. More precisely, a case needs to be made for the choice of MNEs from Germany and

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<sup>72</sup> Strange (1996), p. 17.

Switzerland, the period from 1985 to roughly 1995, pharmaceutical MNEs and banks, and the selected policy issues.

### **Why MNEs from Germany and Switzerland?**

As has been stated earlier, one of this study's goals is to analyse the extent to which institutions are a source of political influence for MNEs. Principally this can be done by comparing MNEs from countries that differ in their institutions or from those that show significant similarities in their institutions. By choosing Germany and Switzerland, this study has opted for the latter option. In both countries, MNEs are part of an institutional structure that decentralises decision-making and awards considerable influence to private actors and especially to the business community. Chapter 4 will show that economic policies in Germany and Switzerland are not simply imposed by the executive but rather reached through regularised, plurilateral bargaining between the key domestic actors – employers' associations, trade unions and the state. In both countries, this form of policy-making is made necessary by the limited capacities of federal, *Länder* and *Cantonal* authorities, which to varying degrees rely on the ability of industry and labour to organise themselves coherently and to cooperate with each other<sup>73</sup>. In this sense the German and Swiss federal governments sit rather uneasily in the conventional strong state-weak state schema. They are both weak and strong at the same time. They are weak because they lack the necessary instruments to impose industrial policies, but they are also strong states because they represent a stable set of institutions, which link the private sector strongly to the public sector. In other words, in both countries institutions can be expected to be a source of political influence for MNEs.

However, while the similarities between the German and Swiss economic policy-making process are significant, there are also important differences. Chapter 4 will point out that decentralisation and consensus-orientation go a lot further in Switzerland and, as a result, policy networks are more tightly knit. Moreover, in contrast to Germany, economic policy-making in Switzerland has in the past often been cartel-friendly. Finally, Germany, as a member of the EU, is in many policy areas bound by supranational law, whereas Switzerland is, at least nominally, free of such constraints.

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<sup>73</sup> See Sally (1993) and (1995) and Katzenstein (1984) and (1989).

## Why the period from 1985 to 1995?

The period from 1985 to roughly 1995 seems to be particularly relevant for an analysis of MNEs' political influence. As has already been pointed out before, the period is characterised by an increasing integration of hitherto largely national economies - a phenomenon often discussed under the term globalisation - which is often seen as a source of additional political leverage for MNEs. By selecting this period for the analysis, this study will try to shed some more light on this hypothesis.

While the current, on-going process of economic integration is certainly not as new as it is often assumed<sup>74</sup>, one can, however, still identify certain novel elements that might indeed have resulted in increased political leverage for MNEs. Essentially the conclusion that MNEs have become politically more powerful in recent years is the result of four separate, yet related, developments. First, during the last four decades governments around the world have been engaged in a non-stop process of dismantling trade barriers within the framework of various GATT rounds, which greatly expanded international trade flows. Second, in the last two decades many developing countries, especially in Latin America and Eastern Europe, embarked on market reforms and began to integrate themselves in the international economy. East Asian emerging markets embarked on this course somewhat earlier and more gradually, accelerating their pace from the early 1980s. Not least due to the increasing outward orientation of these countries, the world has become smaller economically and the number and heterogeneity of countries involved in the international economy have increased substantially<sup>75</sup>. Third, the composition of international trade has changed significantly. While nineteenth century exchanges consisted largely of the sale of food and raw materials from developing countries in return for manufactured goods from developed countries, most of today's trade takes place between developed countries and consists of specialised intra-industry exchanges of manufactured goods and services. In other words, whereas trade a century ago was mostly composed of non-competing products, much of today's trade is in the

<sup>74</sup> Freytag and Sally have pointed out that high levels of economic integration could also be observed in the second half of the nineteenth century. International trade and capital flows were very intense, reaching their zenith in the years immediately preceding World War I. In some countries, such as the Netherlands, the UK, France and Germany, net capital outflows, as a proportion of GDP, were twice as high in 1913 as by the end of the twentieth century. Relative to GDP, balances on the current account in the UK were higher than those of Japan or the US in the 1990s. For similarities and differences between the two periods see Freytag and Sally (2000), p. 2f. See also *The Economist* "One World?" Schools Brief, 18<sup>th</sup> October 1997, pp.103f., Rodrik (1997), pp. 8f.; Bordo, Eichengreen and Irwin (1999) and Bairoch and Kozul-Wright (1998) and Henderson (1998).

<sup>75</sup> Freytag and Sally (2000), p. 3.

form of head-on competition in like or similar products<sup>76</sup>. Finally, technological advances in transport and communication technology and the globalisation of capital markets provided further momentum to these developments.

One of the most tangible effects of these processes was increased pressure on companies to find new ways to improve efficiency and stimulate innovation. Usually this involved “re-engineering” various business activities with the purpose of creating cross-border networks (i.e. in finance, investment, R&D, production) in which each element is carried out in the best-suited location. Ultimately this resulted in extending competition beyond firm-level characteristics to include characteristics of whole production locations, even whole social systems<sup>77</sup>. In the final analysis, it was this development that led to the argument that the increasing integration of national economies has increased the political power of MNEs vis-à-vis states<sup>78</sup>. After all, a company whose facilities are located in a single country has no alternative but to comply with that country’s laws and regulations, whereas a MNE can move production to other countries. Governments, in this view, have little choice but to give in to the demands of MNEs or otherwise face rising unemployment and declining tax revenues. This study will try to shed some more light on this hypothesis.

In some cases the cut off date, 1995, was extended by one or two years since some of the policy issues selected for this analysis began to be debated in the early 1990s but the final bills were only ratified in 1996 or 1997. Since, however, these policy issues were of critical importance for the selected MNEs and the main policy bargaining took place in the first half of the 1990s, it appears legitimate in these cases to have stretched the cut off date a bit.

## **Why pharmaceutical MNEs and banks?**

Analysing and comparing the economic policy preferences and political influence of German and Swiss pharmaceutical MNEs and banks is relevant for a number of reasons. First, the two sectors occupy a central place in their national economies. The pharmaceutical sector in both countries contributes substantially to exports. In 1994, the German pharmaceutical industry was the world’s leading exporter followed by Switzerland (see figure 1.3). In Switzerland more than 90 per cent of drugs were exported in 1994, while for Germany the figure was 30

<sup>76</sup> Ibid.

<sup>77</sup> Recent studies analysing differences in the domestic institutions of market economies include Albert (1993), Garten (1992) and Soskice (1993).

per cent. Moreover, in both countries the pharmaceutical industry plays an important role in the upgrading of the national technology infrastructure and in providing high quality-employment. Due to their research-intensive nature, the pharmaceutical industry's spending on R&D is significantly larger than in other sectors. In fact, the next chapter will point out that it is not unusual for pharmaceutical MNEs to spend between 15 and 20 per cent of sales on R&D.

Similarly, the financial services sector is also of great importance in the two countries and particularly in Switzerland. In an international comparison, the contribution of the banking sector to the Swiss GDP is large. Between 1988 and 1993 it averaged 8.6 per cent, compared with a corresponding figure of between 3 and 4 per cent in Germany. In 1995 the proportion of the total workforce employed in the Swiss banking sector was 3.8 per cent, roughly a third higher than in Germany<sup>79</sup>. Like the pharmaceutical industry, the financial services sector contributes importantly to exports in both countries (see table 1.6).

Second, MNEs from the two sectors differ considerably in their exposure to foreign markets. While the pharmaceutical industry in both has historically been highly internationalised, banks were much less so - at least until the early 1990s. A comparison of the economic policy preferences of MNEs that differ in the degree of their internationalisation

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<sup>78</sup> See for example Strange (1996) and Horseman and Marshall (1994).

<sup>79</sup> See *Swiss Bankers' Association* (1996a), p. 7f.

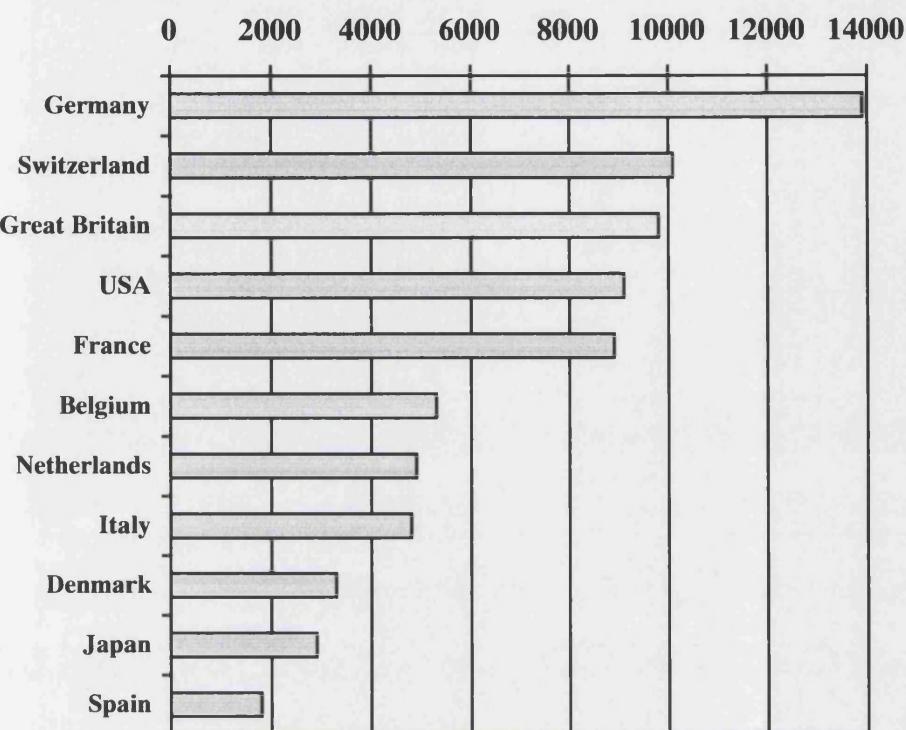


Figure 1.3: Pharmaceutical Exports of Selected Countries (DM bn), 1995.

Source: VCI Foreign Trade Statistics, adapted from VFA Annual Report (1996), p. 32.

Country	1985	1990	1995
France	-	-	8.1
Germany	0.3	4.5	11.1
Japan	0.0	0.1	0.6
Switzerland	1.8	4.2	6.9
United Kingdom	7.3	6.1	9.1
United States	3.0	5.0	7.5

Table 1.6: Financial Services' Exports of selected Countries (US\$ bn).

Source: Adapted from Kono (1997), p. 13, based on IMF data.

should shed more light on the extent to which exposure to international markets is relevant for an explanation of MNEs' economic policy preferences.

Finally, the pharmaceutical and the financial services sector are unique in the sense that, due to sectoral characteristics, markets in both sectors are considerably regulated – something that might encourage MNEs to pursue political strategies to tilt the playing field in their favour. In fact, a number of authors have pointed out that regulation can easily become a means for incumbent firms to limit competition and raise their income at the expense of politically weak consumers and potential entrants<sup>80</sup>. Chapter 3 will analyse these sector-specific regulations and examine whether the 12 MNEs used them as an opportunity for rent-seeking policies.

### **Which Policy Issues?**

Undoubtedly the functioning of competition in the pharmaceutical and financial services industry is affected by numerous factors. However, in both sectors there was a clear consensus among interviewed executives from the 12 MNEs and their trade associations regarding the policy issues that were of greatest significance. In the pharmaceutical sector these were intellectual property rights issues, health care policies, regulations pertaining to the production and approval of drugs derived from the application of biotechnology and, in the German case, parallel imports from other EU member countries. In the financial services sector, issues centred around liberalisation of market access conditions and regulatory issues pertaining to the efficient functioning of the German and Swiss capital markets. Moreover, in Germany the issue of state-sanctioned privileges for public sector banks has been important. The following chapters will now analyse the 12 MNEs' preferences and political influence with regard to these issues.

### **The Plan of the Study**

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<sup>80</sup> See for example Stigler (1971). In fact, a number of authors have pointed out that regulation and prudential supervision in the financial services sector can be a fertile ground for protectionism. See Walter (1985), p. 1 and (1988), pp. 2-4 and Huang (1992), p.3.

Having outlined the main argument of the study and justified the empirical focus, a brief word is in order about how this analysis will now proceed. Chapters 2 and 3 will be concerned with the formation of the 12 MNEs' economic policy preferences. As a first step, Chapter 2 will analyse their business focus and the extent and nature of their internationalisation processes. Chapter 3 will then examine how these factors have interacted with sectoral characteristics to shape the preferences of the 12 MNEs with regard to the selected policy issues. The stage is then set for the analysis to move from the formation of preferences to actual political influence. Chapter 4 will prepare the ground for such an analysis by mapping out the institutions of the German and Swiss policy-making process, and by providing an overview of the economic and political circumstances under which policy-making was taking place during the second half of the 1980s and the first half of the 1990s. Chapters 5 (pharmaceutical MNEs) and 6 (banks) will then focus on the selected policy issues and analyse the causal relationships between interests, institutions and circumstances in shaping the selected MNEs' political influence over actual policy outcomes. Chapter 7 will analyse the 12 MNEs' political influence at the EU level of policy-making and Chapter 8 will summarise the findings of the study and attempt to draw some wider lessons.

## 2

### **Business Focus and Internationalisation Processes of the 12 MNEs**

The purpose of this chapter is to lay the foundation for an analysis of the 12 MNEs' economic policy preferences. To this end, it will examine the business focus and the internationalisation processes of the selected pharmaceutical MNEs and banks. Chapter 1 has pointed out that the literature was unanimous in its finding that MNEs' trade policy preferences were shaped by the extent and nature of their internationalisation process. However, it was argued that if one sought to categorise MNEs' policy preferences as free market, rent-seeking or somewhere in between, it was not sufficient to be merely concerned with trade policies. Domestic economic policies clearly also affected the functioning of price competition and should therefore be incorporated into the analysis. Chapter 1 argued that such a broadening of the analysis required, however, also a broadening of the explanatory framework, since the extent and nature of MNEs' internationalisation processes were unlikely to explain their preferences with regard to domestic policy issues. It was suggested that MNEs' business focus and sectoral characteristics were likely to be important explanatory factors. This chapter will now take the first step towards testing this hypothesis by analysing the business focus and the internationalisation processes of the 12 MNEs. Chapter 3 will then focus on a number of specific policy issues and examine how these two factors have interacted with sectoral characteristics to shape the preferences of the six pharmaceutical MNEs and the six banks.

#### **The Six German and Swiss Pharmaceutical MNEs**

The three German MNEs Hoechst, Bayer and BASF are all, or at least used to be in the case of Hoechst, considerably diversified MNEs that are represented across the spectrum of

chemical activities - from bulk to intermediate to speciality chemicals and pharmaceuticals. Moreover, each one has a proven record of using capital intensity and science-based innovation to diffuse specialisation and value-added to the whole range of its portfolios<sup>1</sup>. Although the three are roughly similar in size (see table 2.1), the scale of their pharmaceutical business varies considerably. In 1994, only Hoechst's pharmaceutical division Hoechst Marion Roussel (HMR) was with annual sales of \$5.2bn among the world's ten largest pharmaceutical MNEs; in the same year Bayer occupied the 13<sup>th</sup> place and BASF the 34<sup>th</sup> (with annual sales of \$3.7bn and \$2bn respectively)<sup>2</sup>.

	Group Sales	Employees	R&D Spending
Hoechst	52.2 (42.7)	161.818 (180.561)	2.9 (2.1)
Bayer	43 (45.9)	146.700 (176.080)	2.6 (2.2)
BASF	46.3 (47.7)	106.565 (130.173)	2.1 (1.9)

Table 2.1: Sales, Employment and R&D Figures for the three German Pharmaceutical MNEs in 1995 (DM bn). 1985 Figures in Brackets. *Source:* Annual Reports.

The three Swiss MNEs Roche, Sandoz and Ciba-Geigy are considerably smaller than the German MNEs (see table 2.2) and are also more focused on the high value-added differentiated product areas of chemicals and pharmaceuticals. In fact, despite being smaller than their German rivals in terms of group sales and employees, their pharmaceutical divisions are all among the world's leading pharmaceutical MNEs. In 1994, Roche was the world's 8<sup>th</sup> largest pharmaceutical MNE with annual sales of \$4.6bn followed by Ciba-Geigy (\$4.3bn) and Sandoz (\$4bn) which occupied places 9 and 10<sup>3</sup>. After Ciba's and Sandoz's merger in 1995, the new entity - Novartis - was the world's third largest pharmaceutical MNEs. However, given the rapid pace of consolidation in the sector, these rankings changed frequently during the last decade.

<sup>1</sup> See Sally (1995), p. 30f.

<sup>2</sup> Quoted in "Pharmaindustrie auf Einkaufstour", *Börsenzeitung*, Jan. 24 1995.

<sup>3</sup> Ibid.

	Group Sales	Employees	R&D Spending
Roche	14.7 (8.9)	50.497 (45.477)	2.3 (1.2)
Sandoz	15.2 (8.5)	49.882 (40.166)	1.5 (0.7)
Ciba-Geigy	20.7 (18.2)	84.077 (81.012)	2.0 (1.8)

Table 2.2: Sales, Employment and R&D Figures for the three Swiss Pharmaceutical MNEs in 1995 (Sfr. bn).

1985 Figures in Brackets. *Source:* Annual Reports

### The Six Pharmaceutical MNEs' Business Focus

At a general level, all six MNEs essentially followed a similar strategy during the last decade: no matter their size or degree of diversification, all of them expanded their pharmaceuticals business, focused on the development of innovative drugs and upgraded their R&D capacities by embracing biotechnology (see next section)<sup>4</sup>. In fact, all of them spent more than 15 per cent of their annual pharmaceutical sales on R&D during the 1990s; Roche, the extreme case, spent 23 per cent on R&D in 1994<sup>5</sup>. Nevertheless there were, however, important differences in the scale and scope with which the six MNEs pursued this strategy.

These differences were particularly visible among the three German MNEs. On one end of the spectrum was Hoechst, which most visibly and strongly subscribed to the concept of the *life sciences* – the hypothesis that advances in biotechnology resulted in similarities at the research level between human, animal and plant health<sup>6</sup>. Starting in the early 90s, under the new CEO Dormann, Hoechst radically re-structured its business operations, began selling large parts of its traditional industrial chemicals business and started to expand its

<sup>4</sup> Sharp (1996) has pointed out that Europe's major pharmaceutical companies have been taking vigorous steps to exploit the potential of biotechnology. See also "1896-1996: Die ersten 100 Jahre", *Roche Magazin Spezial*, Nr. 53 (January), 1996, pp. 52-53; "Pharma mehr denn je", *Schweizerische Handels Zeitung*, May 7 1992; "Des Wundermanagers Strategie", *Basler Zeitung*, May 11 1994; "Die Biologen haben das Wort", *Scheizerische Handels Zeitung*, April 23 1992; "Weg vom Nieschengeschäft", Interview with Ciba-Geigy's chairman Alex Krauer in *Schweizerische Handels Zeitung*, Dec. 14 1989; "Immer mehr Spezialmenüs statt Einheitskost in der Grosschemie", *Frankfurter Allgemeine Zeitung*, Dec. 21 1996 and "Die Branche blickt wie gebannt auf den Pharmamarkt", *Handelsblatt*, May 15 1996.

<sup>5</sup> Annual Reports. See also "1896-1996: Die ersten 100 Jahre", *Roche Magazin Spezial* Nr.53 (January) 1996, pp. 56ff.

<sup>6</sup> Combinatorial chemistry, for example, allows companies to test hundreds of thousands of new compounds against known targets – in bacteria, animals, plants or human tissue; Genomics explores the role of genes in causing illness in living organisms; Bio-informatics allows scientists to cross-reference biological data.

pharmaceuticals division. According to Dormann, Hoechst will soon no longer be known as a diversified chemicals group, but rather as a tightly focused life sciences company<sup>7</sup>.

On the other end of the spectrum was BASF, which has traditionally been heavily involved in bulk chemicals, and is integrated up-stream into raw materials and energy. In contrast to Hoechst, BASF is still focused on chemicals and has stuck to its *Verbund* strategy: integrated chemical sites where the by-products from each process are saved and fed back into the plant to create a variety of other products<sup>8</sup>. However, although BASF did not significantly change its group strategy, it nevertheless expanded and up-graded its pharmaceutical operations (see next section).

Bayer's strategy has been somewhere in between: unlike Hoechst and BASF, it has large activities in both chemicals and pharmaceuticals and has repeatedly stated its intention to remain a diversified chemical MNE. Chairman Schneider believes that there are important synergies between the two areas and has been sceptical about the fashion for de-mergers<sup>9</sup>. Nevertheless, Bayer steadily expanded the life sciences part of its business portfolio during the last decade. While in 1989 pharmaceuticals accounted for 20 per cent of annual sales, their share had climbed to 26 per cent in 1995<sup>10</sup>.

In contrast to the German MNEs, the differences were less pronounced among the three Swiss MNEs: all of them strongly expanded their pharmaceuticals business, albeit in slightly different in ways. Ciba-Geigy and Sandoz followed a similar strategy to that of Hoechst. Both spun off their chemical operations and merged in 1995 to form Novartis. With Ciba strong in human health and Sandoz in nutrition and agriculture, Novartis is often seen as the archetypal life science company. As CEO Vasella put it,

“the common denominator of our business is biology. The research and technology is applied to discover, develop and sell products that have an effect on biological systems, be they human beings, plants or animals”<sup>11</sup>.

<sup>7</sup> Dormann (1996). See also “Going Public via Clariant”, *Börsenzeitung*, Dec. 11 1996; “So schön ist Marion”, *Börsenzeitung*, Nov. 8 1996; “Der grosse Wurf”, *Frankfurter Allgemeine Zeitung*, Dec. 18 1996 and “Im Pharmageschäft bleiben grosse Aufgaben”, *Handelsblatt*, Nov. 13 1996.

<sup>8</sup> Interview.

<sup>9</sup> See “Standortfrage verschärft”, Interview with Manfred Schneider in *Börsenzeitung*, April 27 1995. See also “Restrukturierung einmal anders”, *Handelszeitung*, Dec. 12 1996 and “Fehlt der Bayer Führung der Wagemut”, *Neue Zürcher Zeitung*, March 19 1997.

<sup>10</sup> See Annual Report (1996).

<sup>11</sup> Quoted in “The facts of life”, *Financial Times*, Dec. 9 1998.

While biotechnology has certainly also played a central role in Roche's strategy during the last decade - in the early 1990s Roche was the first of the big pharmaceutical companies to take a billion dollar stake in the then still small biotechnology industry (see next section) – the emphasis has nevertheless been somewhat different. Rather than focusing primarily on synergies at the research level, Roche began during the 1990s to increasingly focus on diagnostics - a development that culminated in 1997 with the acquisition of Boehringer Mannheim, the world's largest diagnostics firm. The former head of R&D, Prof. Drews, noted that this strategy was based on advances in molecular biology. According to him, increasing knowledge of the human genetic code will make it increasingly possible to recognise and quantify illnesses in the human body before they become visible and to develop preventive drugs<sup>12</sup>.

With these strategies the six MNEs essentially responded to two challenges that the pharmaceutical industry was facing during the last decade. First, pharmaceutical MNEs came during the last decade under increasing financial pressure. As a result of strongly increasing health care costs in industrialised countries, governments virtually everywhere started to put pressure on drug prices<sup>13</sup>. While the business with innovative drugs remained lucrative, increasingly cost-conscious national health services and managed care organisations became increasingly unwilling to pay for "me-too" drugs - new pills that offer only slight improvements – and the margins for out of patent generic drugs became also narrower<sup>14</sup>. As a result, MNEs came under intense pressure to develop more innovative drugs<sup>15</sup>. However, it should be noted in this context that financial pressure came also from somewhere else; in fact, just at a time when it became ever more important to bring innovative products to the market, research and development costs strongly increased. While in 1976 it cost on average \$116m to develop a drug, this figure had by 1987 risen to \$287m, and by 1996 to \$500m<sup>16</sup>.

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<sup>12</sup> See Drews (1998).

<sup>13</sup> While in the 1960s most Western European countries spent roughly 4 per cent of GDP on health care, this share had increased by the 1990s to between 8 and 11 per cent. In the US it is 14.2 per cent. See Sommer (1997), p. 9.

<sup>14</sup> See "Nicht mehr die Apotheke der Welt", *Frankfurter Allgemeine Zeitung*, March 5 1996; "The Alchemists", *The Economist*, Feb. 21 1998 and "Globale Fusionitis in der Pharmaindustrie", *Neue Zürcher Zeitung*, Oct. 25/26 1997.

<sup>15</sup> Anderson Consulting estimated that to maintain current annual growth rates of on average ten per cent, pharmaceutical MNEs will have to increase their productivity tenfold, which will require them to launch five new compounds a year, each with an annual sales potential of \$350m. However, in the first half of the 1990s, the world's top ten drug companies launched an average of only 0.45 truly new drugs a year - half of them with sales of less than \$100m annually. See "The Alchemists", *The Economist*, Feb. 21 1998.

<sup>16</sup> See Drews (1998), p. 186. Moreover, it should be pointed that the R&D process in the pharmaceuticals industry is highly uncertain. By one estimate, for every approved drug that comes out of a "pipeline" – the range of compounds firms have in various stages of development in their laboratories – about 10,000 molecules have gone in and lost somewhere on the way. See "The Alchemists", *The Economist*, February 21 1998.

As a result, pharmaceutical MNEs were forced to look for ways to cut costs and enlarge their R&D budgets. Obviously mergers were frequently perceived to be the way forward in this "new strategic environment"<sup>17</sup>.

The second challenge for pharmaceutical MNEs came from technological advances in biotechnology, which promised vastly increased opportunities for the discovery and development of new drugs<sup>18</sup>. Drews has argued that these advances represented a quantum leap in the way drugs were discovered and were holding out the promise of a whole new class of drugs<sup>19</sup>. As has already been argued above, and will be shown in more detail below, all six MNEs strongly embraced biotechnology during the last decade<sup>20</sup>. However, the impact of biotechnology was not only restricted to the possibility of increased innovation. By concentrating on molecular biology (proteins and DNA) rather than traditional chemistry, advances in biotechnology paved the way for a whole new industry of small and medium sized companies which specialised in moving lots of molecules along short segments of the pipeline for other companies. This, in turn, provided opportunities for the large pharmaceutical companies to increasingly outsource business activities<sup>21</sup>. In fact, as will be shown below, all of the selected MNEs became increasingly keen during the last decade to acquire or forge alliances with small and medium-sized biotechnology companies. The challenge, so it seemed, had become one of being big and small at the same time.

Having examined the six pharmaceutical MNEs' business focus and located them in their sectoral context, the study can now move on to analyse their internationalisation processes.

<sup>17</sup> Mergers and acquisitions amounted to more than \$100bn in the first half of the 1990s. Prominent examples included the acquisition of American Cyanamid by American Home Products, the mergers of Glaxo and Wellcome, Ciba Geigy and Sandoz, the acquisition of Marion Merrell Dow by Hoechst and the acquisition of Boehringer Mannheim by Roche. See for example "Globale Fusionen in der Pharmaindustrie", *Neue Zürcher Zeitung*, Oct. 25/26 1997.

<sup>18</sup> Biotechnology encompasses a multitude of research and production methods comprising all techniques which use living organisms or parts of living organisms for the production of agricultural or pharmaceutical products or the development of micro-organisms for a variety of purposes. In this sense it is not a new technology, but rather encompasses techniques, which have been used for centuries in the production of bread, wine, beer or cheese or in the breeding of animals or plants. Contemporary discussion focuses typically on one aspect of biotechnology: gene technology, which refers to processes intended to isolate, analyse, describe and recombine DNA. See Klodt and Stehn (1994), p. 58.

<sup>19</sup> Drews (1998), p. 113. Traditionally illnesses were analysed as distortions of the chemical balances in the human body. Molecular biology, however, is based on information analysing life as a programme embodied or codified in genes. As a result, illnesses can be interpreted as either information deficits or information surpluses thereby offering a new, universally applicable entry to medicine - a sort of a master key. See Drews (1998), p. 111.

<sup>20</sup> See for example "Auf die richtigen Gene kommt es an", *Neue Zürcher Zeitung*, Dec.30/31 1995 and "Die Branche blickt wie gebannt auf den Pharmamarkt", *Handelsblatt*, May 15 1996.

<sup>21</sup> Big drug companies have, for example, increasingly started to outsource clinical trials - the last and most expensive part of the development process – as specialised companies came up with innovative ways of extracting the maximum of information from the minimum number of trials. See "The Alchemists", *The Economist*, Feb. 211998.

### The Three German Pharmaceutical MNEs: Hoechst, Bayer and BASF

All three German MNEs share a history of extensive internationalisation. Sally has pointed out that all three had a long record of multinational investment in the last century, which was only punctured by forced divestment during both World Wars. During the interwar period Hoechst, Bayer and BASF formed the IG Farben cartel, which was broken up into its original constituents after 1945<sup>22</sup>. During the following decades, the three MNEs build up substantial international business operations, first in their main regional market, the European Community, but also in the US and more recently in Asia (see below). However, it should be noted that while the three MNEs' sales have long been highly internationalised (see table 2.3), their production networks used to be a lot less so. In fact, until the late 1980s all three MNEs were following a similar strategy of concentrating high value added production and R&D activities in Germany<sup>23</sup>.

	Hoechst	Bayer	BASF
Germany	- (25.3)	18.6 (25.7)	27.2 (32.7)
EU	51.8 <sup>a</sup> (34.0)	32.6 (33.1)	37.1 (32.4)
US	29.4 (21.2)	27.9 (24.3)	19.4 (19.3)
Asia	9.2 (8.9)	12.6 (8.2)	10.0 (7.4)
South America	7.4 (7.6)	7.0 (6.1)	4.9 (5.6)

Table 2.3: International Sale Figures for Hoechst, Bayer and BASF in 1995 (as % of total sales). 1985 Figures in Brackets. *Source:* Annual Reports, own calculations.

<sup>a</sup>includes Germany

Turning now to the three MNEs' pharmaceutical divisions, Hoechst's pharmaceuticals business is not only the largest of the three German MNEs, but also the most internationalised. While all of the selected Swiss and German MNEs sell a substantial amount of their products in the triad economies, Hoechst's pharmaceutical division HMR is the only

<sup>22</sup> See Sally (1995), p. 30.

<sup>23</sup> Interviews.

one which is almost equally strongly represented in all triad economies. In the US it has a market share of almost 4 per cent, only slightly higher than in Europe and the Pacific region where it has 3 per cent. HMR's most important market is the US, which in 1995 generated sales of almost DM 2bn followed by France (1.5bn), Japan (1.4bn) and Germany (1.3bn)<sup>24</sup>.

Hoechst mainly internationalised and expanded its pharmaceuticals business through two major acquisitions. In 1974 it bought the French pharmaceutical MNE Roussel Uclaf and in 1995 the American pharmaceutical MNE Marion Merrel Dow. The latter acquisition was particularly significant for the size and internationalisation of Hoechst, since it raised its market share in the US from one to four per cent<sup>25</sup>. In 1998, Hoechst decided to merge HMR with the pharmaceuticals division of the French MNE Rhône-Poulenc. Despite being a strongly research-oriented pharmaceutical MNE that focuses on the development of prescription drugs, HMR has recently also diversified into generic products. In 1993, it acquired a majority stake in the American generic products producer Copley Inc. and by 1996 HMR was the fourth largest producer of generic products worldwide<sup>26</sup>.

During the late 1980s and early 1990s Hoechst also started to internationalise high-value added business activities which used to be carried out in Germany. While by 1990 the production of high-value added drug ingredients used to be carried out pre-dominantly at headquarters in Germany, the German share of the production network had by 1996 dropped to 40 per cent<sup>27</sup>. During this period, R&D activities were also increasingly decentralised away from headquarters. In the late 1980s and early 1990s, Hoechst set up R&D facilities in France, Japan and the US and signed a number of co-operation arrangements with small American biotechnology companies and universities (i.e. with Massachusetts General Hospital, a teaching hospital belonging to Harvard University). In 1995, less than a third of the total R&D budget was allocated to the German research locations and in 1996, HMR announced that the worldwide centre of drug development would be moved to Sommerville in the US where HMR would also concentrate its genetic research<sup>28</sup>. Commenting on the increasing internationalisation during the 1990s, Dormann likes to refer to HMR as no longer a German company with a lot of subsidiaries abroad, but rather as a company "on the way of becoming a globally operating pharmaceutical multinational headquartered in Germany"<sup>29</sup>.

<sup>24</sup> See "Die Fakten über HMR", Hoechst (1996).

<sup>25</sup> See Dormann (1996).

<sup>26</sup> See "Der grosse Wurf", *Frankfurter Allgemeine Zeitung*, Dec. 18 1996.

<sup>27</sup> See Dormann (1996).

<sup>28</sup> See "Die Fakten über HMR", Hoechst (1996).

<sup>29</sup> See Dormann (1996) and "The lazy man in Europe", *Wall Street Journal*, Feb. 18 1997.

Similar to Hoechst, Bayer was already by the mid-1980s highly internationalised and conducted about 80 per cent of its business abroad<sup>30</sup>. Unlike Hoechst, however, Bayer started early to establish a presence in the US market. In 1973 it acquired Cutter Inc. and in 1978 Miles laboratories, which became its main US subsidiary. By 1995, Miles had 50 production locations – in the US and abroad – and 80 per cent of the products sold by Miles were produced in the US; sales in the US market in the same year accounted for 24 per cent of overall sales<sup>31</sup>. During the early 1990s, Bayer started to strengthen its position in Asia. Particular focus was on Japan, where by 1995 Bayer's sister company Bayer Yakuhin was among the country's ten largest pharmaceutical companies<sup>32</sup>.

The 1990s saw also a steadily increasing internationalisation of Bayer's R&D activities. CEO Schneider argued that the globalisation of R&D activities had become a primary goal of Bayer since it was essential to have access to the innovation potential of the leading scientific countries"<sup>33</sup>. Apart from a handful of European locations, Bayer has a research facility in the US (established in 1988) and in 1995 it opened one in Japan. Research involving biotechnology is largely carried out through Miles in the US. During the early 1990s, Bayer also acquired two small biotechnology companies in the US (Diamond Inc. and Scientific Inc.) and the diagnostics business of Chiron<sup>34</sup>. However, despite this increasing internationalisation, R&D activities are still relatively concentrated in Germany. In 1995, 60 per cent of the R&D budget was allocated to the German facilities<sup>35</sup>. However, Schneider has repeatedly argued that the majority of new investments were shifting towards foreign markets<sup>36</sup>.

BASF started to diversify into pharmaceuticals in 1968 with the acquisition of Nordmark Werke in Germany. This step was followed by two further acquisitions: in 1971, BASF acquired 50 per cent of Laboratoire Biosedra in France and, in 1975, the German Knoll AG. In 1983 the three companies were merged under the name of Knoll AG, which henceforth carried out all of BASF's pharmaceuticals business. By 1992, Knoll had 30 foreign subsidiaries, three quarters of its sales came from abroad and more than half of its workforce worked outside of Germany<sup>37</sup>. However, until the mid-1990s, the pharmaceuticals business

<sup>30</sup> "Namen, Zahlen, Fakten", Bayer (1996).

<sup>31</sup> See "Bayer hisst die Flagge in den USA", *Börsenzeitung*, Jan. 13 1996.

<sup>32</sup> See "Bayer ordnet Pharmageschäft neu", *Börsenzeitung* April 1 1995.

<sup>33</sup> See "Standortfrage verschärft", Interview with Manfred Schneider in *Börsenzeitung*, April 27 1995.

<sup>34</sup> See "Bayer Forschung wird internationaler", *Börsen Zeitung*, May 23 1995 and "Bayer entwächst dem Standort Deutschland", *Neue Zürcher Zeitung*, March 22 1995.

<sup>35</sup> See "Namen, Zahlen, Fakten", Bayer (1996).

<sup>36</sup> See "Bayer ordnet Pharmageschäft neu", *Börsenzeitung*, April 1 1995.

<sup>37</sup> See Knoll AG Information Brochure, July 1994.

played a relatively low profile role in BASF's operations. In 1994, however, BASF decided to upgrade and further internationalise Knoll's operations. In the same year Knoll diversified into generic drugs by acquiring the Austrian drugs company Sagitta Arzneimittel, followed by a joint venture with the American drugs company Ivax for the marketing of generic products in Europe. In 1995, BASF made its so far biggest step towards expanding its pharmaceuticals business with the acquisition of the British pharmaceuticals MNE Boots. After the acquisition, Germany's share of sales dropped to less than 20 per cent and the US share rose to almost 35 per cent. Europe, without Germany, accounted for 30 per cent. The acquisition also raised BASF's market share in the US, Great Britain and France to over 1 per cent. In Germany, Italy and Spain, BASF has 2 per cent<sup>38</sup>. In 1996 BASF took a first step towards increasing its presence in Asia by acquiring a majority stake in the Japanese pharmaceuticals company Hokuriko Seiyaku.

Similar to its two German rivals, BASF has also started, albeit slowly, to internationalise its research activities. In 1988, BASF set up a research facility in Worcester, MA. and over the following years it signed a number of co-operation arrangements with small American biotechnology companies. More recently, BASF has set up research facilities in Japan, France and Great Britain and has voiced intentions to develop an international division of labour for its R&D activities<sup>39</sup>. Despite this recent, expansion, however, BASF's pharmaceuticals' business remains considerably smaller than that of Bayer and Hoechst.

### **The Swiss pharmaceutical MNEs: Roche, Sandoz and Ciba-Geigy**

Similar to the German MNEs, but even more so, the three Swiss MNEs have long been highly internationalised. Due to the diminutive size of their Swiss home market, they had little choice but to expand internationally. Already by the mid-1980s, the starting point of this analysis, home market sales at all three MNEs accounted for only a tiny fraction of annual sales: 2 per cent at Ciba-Geigy, 3.3 per cent at Roche and 3.7 per cent at Sandoz (table 2.4 summarises international sales figures for 1985 and 1995). However, again similar to the German MNEs, their production networks used to be a lot less internationalised. In fact, all three MNEs used to concentrate high value-added research and production activities in

<sup>38</sup> "Das Mauerblümchen soll zur guten Fee werden", Interview with Knoll's CEO Thorsten Spickschen in *Chemische Industrie* 5/1995.

<sup>39</sup> Knoll AG Information Brochure, July 1994.

Switzerland and export semi-finished products to foreign subsidiaries for the final stages of (lower value-added) production, packaging and marketing<sup>40</sup>.

	Roche	Sandoz	Ciba-Geigy
Switzerland	2.0 (2.9)	2.7 (4.2)	- (2.0)
EU	35.2 (34.0)	43.4 (45.6)	41.4 <sup>a</sup> (39)
US	39.7 (40.4)	41.4 <sup>b</sup> (40.6) <sup>b</sup>	40.6 <sup>b</sup> (35)
Asia	12.6 (10.4)	10.5 (7.0)	15.8 (11)
South America	8.9 (9.7)	- -	- (10)

Table 2.4: International Sales Figures for Roche, Sandoz and Ciba-Geigy in 1995 (in % of total sales).

1985 Figures in Brackets. *Source:* Annual Reports, own calculations.

<sup>a</sup>includes Switzerland

<sup>b</sup>includes South America

Turning now to the three MNEs' pharmaceuticals' business, Roche was clearly the most acquisitive of the three during the last decade. In 1990, it acquired a majority stake in the US firm Genentech, one of the world's largest biotechnology firms, and in 1994, it acquired the American pharmaceutical MNE Syntex. With production locations in 30 countries, Syntex not only significantly expanded Roche's international production network, but its annual sales of \$2.1bn also significantly increased Roche's market share in the US; in fact, the acquisition turned Roche into the 6<sup>th</sup> largest pharmaceutical MNEs in the US (before the acquisition it was the 15<sup>th</sup> largest)<sup>41</sup>. In the early 1990s, Roche also further internationalised its OTC business through acquiring Nicholas Corporation and the OTC division of the British pharmaceuticals group Fisons<sup>42</sup>. In 1997, Roche acquired Boehringer Mannheim – the worlds' largest diagnostics firms – in what was to date Roche's largest acquisition. By 1995

<sup>40</sup> See Bauer (1981), p. 236, quoted in Sally (1993), p. 564.

<sup>41</sup> See "Roche jetzt weltweit Nummer vier", *Basler Zeitung*, May 10 1995.

<sup>42</sup> See "Roche jetzt weltweit Nummer vier", *Basler Zeitung*, May 10 1995; "Regenschutz unter Schweizer Dach" *Scheizerische Handelszeitung*, May 5 1994 and "Die Pharmabranche in einer Fusionstherapie" *Neue Zürcher Zeitung*, May 7/8 1994.

domestic sales had shrunk to 2 per cent of overall sales; Europe and North America both contributed 37 per cent, while Asia accounted for 14 per cent<sup>43</sup>.

Starting in the late 1980s, Roche also began to increasingly internationalise its research activities. During the early 1990s, it opened research facilities in Britain, France and the US and signed a number of co-operation arrangements with small American biotechnology companies. In 1991, Roche started to concentrate its biotechnology research at its research facility in Nutley, New Jersey. By 1994, the US facilities consumed half of Roche's R&D budget with Britain and Japan accounting for 10 per cent<sup>44</sup>. Moreover, Roche also significantly decentralised its R&D activities by organising them into semi-autonomous units, while trying to maintain cross-fertilisation through frequent travel and meetings between researchers<sup>45</sup>. Genentech, for example, operates absolutely independently despite Roche's majority stake, and Roche Bioscience in Palo Alto works as a de facto independent company<sup>46</sup>. Roche also appeared to be the fastest of the six MNEs to discover outsourcing. Protodigm, for example, its UK-based sister company, is a ten-employee "virtual company" which acquires new molecules from, for example, university laboratories and then contracts several other companies to conduct the various clinical tests, production processes, registration procedures and marketing and sales activities. Since Protodigm can select for each phase the most qualified partner, Roche hopes that this will reduce costs and shorten development periods<sup>47</sup>. Alongside this increasing internationalisation during the early 1990s, Roche's investments in its home market diminished significantly. While in 1986 Switzerland accounted for 40 per cent of all new investments, this percentage had by 1992 dropped to 27 per cent<sup>48</sup>.

Similar to Roche, Sandoz's major markets are the triad economies, and particularly the US where sales have been growing fast during the early 1990s. While in 1989 the US market accounted for 25 per cent of sales, this figure had by 1995 risen to 33 per cent<sup>49</sup>. In the same year, home market sales accounted for a mere 3 per cent.

Sandoz's business focus shifted during the first half of the 1990s strongly towards the *life sciences*: the chemical business was sold in 1995 and pharmaceutical and nutrition operations

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<sup>43</sup> Annual Report 1996.

<sup>44</sup> "1896-1996: Die ersten 100 Jahre" *Roche Magazin Spezial*, Nr. 53 (January) 1996, p. 61.

<sup>45</sup> Interview.

<sup>46</sup> See footnote 44.

<sup>47</sup> Interview. See also "Das virtuelle Unternehmen", *Neue Zürcher Zeitung*, Oct. 25/26 1997.

<sup>48</sup> "Der Roche-Konzern hat Erfolg und Glück gepachtet", *Basler Zeitung*, April 23 1993.

<sup>49</sup> See "Für Ciba und Sandoz ist die Schweiz ein kleiner Markt", *Neue Zürcher Zeitung*, March 11 1996 and "Sandoz: Die Hälfte der Pharma wird verlagert", *Basler Zeitung*, Aug. 13 1994.

were expanded – the latter particularly in 1994 through the acquisition of the American baby foods company Gerber. By 1995, the *life science* division accounted for 70 per cent of annual sales<sup>50</sup>.

During the 1990s, Sandoz also started to increasingly internationalise its high-value added production activities, which had hitherto been largely concentrated at headquarters in Basle<sup>51</sup>. In 1990 Sandoz's chairman, Marc Moret, announced that he aimed to reduce the Basle share in the production of pharmaceuticals to 60 per cent<sup>52</sup>. An important step towards this goal was Sandoz's decision in 1990 to build a large pharmaceutical factory in Ireland for the production of, among other things, 20 per cent of the active ingredients in drugs. In 1994, Sandoz went a step further and announced that half of its entire pharmaceutical production would be moved to its new production facility in Ireland<sup>53</sup>.

While Sandoz did not acquire a major pharmaceutical producer, it acquired two medium-sized American biotechnology companies (SyStemix in 1991 and Genetic Therapy in 1995) and signed a number of co-operation arrangements with biotechnology companies (i.e. Biotransplant) and American universities (e.g. the Deaconess Hospital of Harvard University)<sup>54</sup>. Shortly before merging with Ciba to form Novartis, Sandoz also acquired the German generic drugs firm Azupharma, making the merged Sandoz-Ciba generic drugs operations the world's largest<sup>55</sup>. During the late 1980s, Sandoz also made first steps to internationalise its research activities, which had hitherto been largely concentrated at headquarters in Basle. By 1992, Sandoz had set up research locations in the US, Japan and Great Britain<sup>56</sup>. Similar to Roche, Sandoz's investments in Switzerland markedly decreased during the 1990s. While in the late 1980s around 30 per cent of all new investments were undertaken in the Basle region, this proportion had sunk to 20 per cent in 1992 and 15 per cent in 1994 and consisted largely of mere maintenance and rationalisation investments<sup>57</sup>.

Like its two Swiss rivals, Ciba-Geigy was also already highly internationalised by the mid-1980s. As noted earlier, already in 1985 Ciba only sold 3 per cent of its products in its

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<sup>50</sup> See "Sandoz konzentriert sich künftig auf Pharma und Ernährung", *Basler Zeitung*, March 24 1995.

<sup>51</sup> See "Wir haben zu grosse Ballungen", Interview with Marc Moret in *Schweizerische Handels Zeitung*, Feb. 15 1990.

<sup>52</sup> *Ibid.*

<sup>53</sup> See "Sandoz: Die Haelfte der Pharma wird verlargert", *Basler Zeitung*, Aug. 13 1994.

<sup>54</sup> See "Sandoz übernimmt US Forschungsinstitut", *Neue Zürcher Zeitung*, July 11 1995.

<sup>55</sup> See "Von Ciba und Sandoz zu Novartis", *Neue Zürcher Zeitung*, March 8 1996.

<sup>56</sup> See "Sandoz zieht Ausland vor" *Schweizerische Handelszeitung* March 5 1992 and "Neue Strukturen bei Sandoz Pharma", *Basler Zeitung*, Dec. 10 1993.

<sup>57</sup> See "Sandoz: Standort Basel verliert laufend an Gewicht", *Basler Zeitung*, April 19 1994.

home market (by 1995 the figure had dropped to 2 per cent) and employed less than a quarter of its workforce in Switzerland<sup>58</sup>.

During the late 1980s and the first half of the 1990s, Ciba took further steps to increase its internationalisation. In Europe, where Ciba sells 45 per cent of its products, it upgraded its production facilities in Italy, Spain, France and the UK and built a new facility in Spain<sup>59</sup>. In 1992, Ciba bought the British pharmaceutical MNE Fison. In the US, where Ciba sells 30 per cent of its products, Ciba added in 1985 diagnostics to its life science portfolio through the establishment of the Ciba Corning Diagnostics Corporation - a joint venture with the US pharmaceutical MNE Corning Glass. In 1987 Ciba upgraded its US operations through a new production facility in New Jersey<sup>60</sup>. Also in the mid-1980s, Ciba started to increasingly expand in Asia - a region where it had hitherto lacked a significant presence. In 1988, Ciba started to transform its facility in China to a full-scale manufacturing location and, by 1994, China was the country receiving most of Ciba's investments<sup>61</sup>. Contrary to its two Swiss rivals, Ciba did not acquire an American biotechnology company but preferred co-operation arrangements and minority stakeholdings. Examples include a joint venture with Biocine in California and minority stakes in Chiron, one of the world leading biotechnology companies, and Myriad Genetics. In 1994, Ciba raised its stake in Chiron to 49.9 per cent - an investment worth \$2.1bn<sup>62</sup>.

Similarly to its two Swiss rivals, Ciba also started to increasingly internationalise its R&D activities, which used to be largely concentrated in Basle. By the early 1990s, Ciba had established facilities in the US, Japan, England, Germany, France and Italy and new research projects involving biotechnology were increasingly carried out in foreign locations<sup>63</sup>. A particularly significant decision in this respect was made in 1991, when Ciba, after long and highly politicised negotiations with the Basle cantonal administration, decided to abandon its plans for a new biotechnology research facility in Basle, and instead built the facility just across the French border in the Alsace. Ciba's chairman, Alex Krauer, commented that "the political climate was not right for expanding biotechnology research in Basel"<sup>64</sup>. Nevertheless Ciba continued to spend slightly more than 50 per cent of its R&D budget in Switzerland and,

<sup>58</sup> See "Für Ciba und Sandoz ist die Schweiz ein kleiner Markt", *Neue Zürcher Zeitung*, March 11 1996.

<sup>59</sup> See "Ciba-Geigy und der Standort Schweiz", *Neue Zürcher Zeitung*, April 23 1994.

<sup>60</sup> *Ibid.*

<sup>61</sup> See "Ciba-Fabrik in China eingeweiht", *Basler Zeitung*, Oct. 21 1993 and "Ciba auf Expansionskurs in China", *Neue Zürcher Zeitung*, Sept. 8 1994.

<sup>62</sup> See "Die Perlenfischer vom Rhein", *Cash*, Nr. 37, Sep. 15 1995.

<sup>63</sup> Interview.

<sup>64</sup> Quoted in *Finanz und Wirtschaft*, Dec. 18 1991.

in 1994, Ciba invested Sfr. 40m in a new research facility in Basle. Overall, however, new investments were predominantly abroad in the 1990s<sup>65</sup>.

### The Extent and Nature of the Six Pharmaceutical MNEs' Internationalisation Process

The analysis has shown that all six MNEs' international sales considerably exceeded their domestic sales. In fact, in the Swiss case, domestic sales were as low as two per cent. Moreover, this has not been a recent phenomenon. Already by the mid-1980s – the starting point of this analysis – the six MNEs were highly internationalised (see table 2.5). As Alex Krauer has put it, "the pharmaceuticals industry was already globalised before the term was invented"<sup>66</sup>. If anything, the extent of six MNEs' internationalisation further increased during the last decade. It was shown that, with varying degrees, all six MNEs further increased their market share in foreign markets. Indeed, if one believes the extent of a firm's international sales to be a reliable indicator for its trade policy preferences, one would be hard put not to expect the six MNEs to be among the worlds' most free trade minded companies.

	Foreign Sales (%)	Employees abroad	% of total Employees	R&D Abroad (%)
Hoechst	81.2 (74.7)	80.765 (76.383)	49.9 (42.3)	58.6 (28.5)
Bayer	81.4 (74.3)	70.875 (-)	48.3 (-)	39.5 (-)
BASF	72.8 (67.3)	42.987 (41.658)	40.4 (32.0)	33.3 (-)
Roche	98.0 (97.1)	40.422 (35.865)	80.0 (78.9)	- (-)
Sandoz	97.3 (95.8)	35.689 (33.143)	71.6 (82.5)	46.6 (35.6)
Ciba-Geigy	97.8 (98.0)	61.432 (58.097)	73.1 (71.7)	45.8 (-)

Table 2.5: Figures relating to the Six Pharmaceutical MNEs Internationalisation Process in 1995. 1985 Figures in Brackets. *Source:* Annual Reports, own calculations.

<sup>65</sup> See "Ciba-Geigy und der Standort Schweiz", *Neue Zürcher Zeitung*, April 23 1994.

<sup>66</sup> See Interview with Alex Krauer in *Schweizerische Handelszeitung*, Dec. 14 1989. See also "Die Branche blickt wie gebannt auf den lukrativen Pharmamarkt", *Handelsblatt*, May 15 1996.

With regard to the nature of the six MNEs' internationalisation processes, there have been significant changes under way during the 1990s. It was noted earlier that while the six MNEs' sales had always been highly internationalised, their production networks were a lot less so. In fact, MNEs in both countries followed a similar strategy of concentrating high value-added production activities in their home countries. Only low-value added activities, such as packaging or marketing activities, tended to be carried out from production locations abroad. Sandoz, the extreme case, had by 1990 still 95 per cent of its pharmaceutical production located in Basle<sup>67</sup>. However, during the late 1980s and early 1990s, this strategy began to change. Responding to the need for greater innovation, all six MNEs started to increasingly internationalise their R&D activities in order to tap the research potential of different regions. It was shown that all six set up research locations abroad - particularly in the San Francisco bay area and New England<sup>68</sup> - and began to collaborate with small and medium-sized US biotechnology companies, either through strategic partnerships, minority shareholding or outright acquisitions<sup>69</sup>.

The increasing internationalisation of R&D activities had also implications for MNEs' production arrangements, since new drugs tend to be produced at the location where they were discovered and developed<sup>70</sup>. Consequently, a significant amount of production activities followed – and is about to follow – the internationalisation of R&D. Moreover, with the increasing internationalisation of production networks, it also became easier for firms to compare production costs across different locations, which led to yet more internationalisation as a result of cost-optimising strategies. One Swiss executive remarked that "cross-subsidisation became increasingly visible and intolerable"<sup>71</sup>.

Using Bartlett and Goshal's often quoted terminology to locate these developments within a larger conceptual context, it appeared that the six MNEs were firmly on the way towards becoming *integrated production networks* – the authors' organisational concept with the highest degree of internationalisation. *Integrated production networks* are characterised by a cross-border organisational structure in which sister companies or subsidiaries do not play uniform roles, but rather according to the importance of their contribution to operations<sup>72</sup>.

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<sup>67</sup> See Sally (1993), p. 564.

<sup>68</sup> "Die Perlenfischer vom Rhein", *Cash*, Nr. 37 Sep. 15 1995.

<sup>69</sup> The German Ministry of Science estimated that in 1993, 75 per cent of the German pharmaceutical industries' new investments went to the US. Quoted in Klodt and Stehn (1994), p. 65.

<sup>70</sup> See Boston Consulting Group (1995). See also "Roche: Ohne Forschung keine Produktion", *Basler Zeitung*, Aug. 20 1994.

<sup>71</sup> Interview.

<sup>72</sup> Bartlett and Goshal (1989), p. 60.

To be sure, the internationalisation of R&D activities and production networks was not equally advanced at all six MNEs; Bayer, and certainly BASF, appeared to be somewhat behind when compared to the other four. However, it appears unlikely that these differences should become visible in the six MNEs' trade policy preferences; clearly, all six are internationalised to a degree that makes it highly unlikely that they will support market-closing trade policies.

## The Six German and Swiss Banks

Similar to the three German pharmaceutical MNEs, the three German banks Deutsche Bank, Dresdner Bank and Commerzbank are considerably "diversified MNEs". All of them are commonly referred to as *universal banks*, in the sense that they are active in all business segments of the banking sector. Nevertheless - and in stark contrast to the pharmaceutical MNEs - all three banks' business focus has traditionally been strongly on the domestic market or, more precisely, on the channelling of savings to domestic industry. In return, banks often acquired not insignificant stakes in their client companies and obtained seats on their supervisory boards. As will be pointed out in the following chapter, this role was part and parcel of Germany's system of *organised capitalism*.

The three banks' size differs, however, considerably (see table 2.6). Measured by balance-sheet size<sup>73</sup>, Deutsche Bank, Dresdner Bank and Commerzbank were in 1995 Germany's three biggest banks, yet in an international comparison only Deutsche Bank could be found among the world's leading banks. After taking over Bankers' Trust in 1998, Deutsche was estimated to be the world's biggest bank by assets. By an earlier estimate, Dresdner Bank and Commerzbank ranked 24<sup>th</sup> and 37<sup>th</sup> respectively<sup>74</sup>.

Although Credit Suisse, SBC and UBS are also referred to as *universal banks* with a traditional focus on channelling customers' savings to domestic industry, their securities business has always been more substantial than that of the German banks. Also, unlike the

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<sup>73</sup> Balance sheet size is, however, not an entirely reliable indicator for the size of a bank, since with securitisation a lot of banks' business has been pushed off-balance sheet.

	Balance Sheet Size	Employees
Deutsche Bank	721.7 (243)	74.119 (48.851)
Dresdner Bank	484 (192)	46.890 (33.098)
Commerzbank	404 (137.2)	29.615 (24.154)

Table 2.6: Balance Sheet Size in DM bn and Employees of the Three German Banks in 1995. 1985 Figures in Brackets. *Source: Annual Reports.*

German banks, the Swiss banks were always more internationalised, mainly due to the attractiveness of Switzerland as a financial centre. Chapius has noted that this allowed the Swiss banks to do a substantial amount of international business from Switzerland<sup>75</sup>. They were particularly benefiting from their tradition of portfolio managers, the stringent upholding of banking secrecy laws, a well functioning financial system and the stability and of the Swiss franc<sup>76</sup>. One Swiss executive remarked that “these factors combined to encourage a large number of affluent foreigners to travel to Switzerland for the management of their assets”<sup>77</sup>. Chase Manhattan has estimated Switzerland’s share of the international portfolio management business with private customers at around 35 per cent<sup>78</sup>.

Moreover, in contrast to the German banks, the difference in size was less pronounced among the three Swiss banks, which together accounted for half of Switzerland’s banking assets<sup>79</sup>. Although the three banks’ balance sheet size was comparable to that of Dresdner Bank and Commerzbank (see table 2.7), all three were generally considered to be among the world’s leading banks. In 1991, the *Wall Street Journal* predicted that all three would be among the dozen or so major global players by the end of the century<sup>80</sup> - an assessment that was apparently, however, not shared by SBC and UBS, which decided to merge in 1997 in order to cut costs and increase their financial clout.

<sup>74</sup> See “Japan hat the grössten Banken der Welt”, *Frankfurter Allgemeine Zeitung*, July 16 1993 and “Die stärksten Investmentbanken der Welt”, *Frankfurter Allgemeine Zeitung*, Oct. 27 1993.

<sup>75</sup> See Chapius (1985), p. 86.

<sup>76</sup> See *UBS International Finance*, Winter 1991 and Braillard (1987).

<sup>77</sup> Interview.

<sup>78</sup> See *Swiss Bankers’ Association* (1996).

<sup>79</sup> See “New Challenges for Switzerland’s Banking Industry”, *Economic and Financial Prospects*, No. 1, February/March 1996.

<sup>80</sup> Quoted in “SBG, SBV, SKA ganz vorne dabei”, *Basler Zeitung*, March 26 1991.

	Balance Sheet Size		Employees	
Credit Suisse	244.6	(88.7)	26.164	(12.743)
SBC	288.3	(127.9)	27.237	(14.825)
UBS	386.8	(139.5)	29.071	(18.677)

Table 2.7: Balance Sheet Size in Sfr. bn and Employees of the three Swiss Banks in 1995. 1985 Figures in Brackets. *Source: Annual Reports.*

### The Business Focus of the Six Banks

Seen from a general level, all six banks developed their business during the last decade in essentially the same direction. While timing and scale of the major strategic moves may have varied (see next section), the underlying objectives were largely identical. Apart from Germany's Commerzbank, all six banks internationalised their commercial banking activities selectively and defensively, and pushed aggressively into the securities business. Except for Commerzbank, all of them built up substantial investment banking and asset management capacities and strongly internationalised these businesses from the start. Lately, however, Commerzbank has also increased its efforts to build an international investment banking business.

At a basic level, these strategies were a response to two challenges that were confronting the financial services sector during the 1980s and 1990s. One concerned commercial banking (banks' traditional loan and retail business) and the other investment banking and asset management. In commercial banking, the challenge came from rapidly internationalising domestic corporate customers, which began to demand an increasingly sophisticated array of financial services in their host countries<sup>81</sup>. Ultimately, this presented banks with the choice of either setting up international branches themselves, or otherwise risk losing their clients to foreign banks – something, which might eventually have negative implications for long-term client relationships in banks' home countries<sup>82</sup>.

<sup>81</sup> See OECD (1985), p.15. See also Fieleke (1977), Khoury (1980), Goldberg and Saunders (1981) and Sabi (1988).

<sup>82</sup> See for example "Wir verlagern nicht ins Ausland – wir folgen unseren Kunden" Interview with Credit Suisse's former Board President Robert Jeker in *Badener Tagblatt*, July 25 1992. See also Weiss (1990) and Büschgen (1992).

The second challenge concerned the securities business of banks - investment banking and asset management. Change resulted primarily from structural deregulation policies pursued by a large number of countries during the 1970s and 1980s and from the increasing popularity of credit instruments that can be traded in financial markets – a phenomenon often referred to as securitisation or disintermediation<sup>83</sup>. During the last two decades, securitisation became widely perceived to be a better technique than bank lending, since by spreading the risk of a loan among many borrowers and by providing traded markets (so that lenders can adjust their risks more easily) it lowered the costs of borrowing<sup>84</sup>. As a result, the capacity to trade shares, place them in the market and provide technical expertise of how to raise funds in the financial markets became ever more important for banks<sup>85</sup>. A number of authors have observed that this development - together with vast improvements in information technology - led to the emergence of global capital markets and forced banks wishing to participate in these markets to establish subsidiaries in the world's major financial centres<sup>86</sup>.

However, securitisation changed the rules of the game also in another way. As investment and commercial banks began suddenly to compete in the same market, competition increased significantly, which in turn led to the development of innovative and ever more efficient financial products<sup>87</sup>. Mühlemann has pointed out that this development ultimately resulted in the blurring of yet another traditional demarcation line in the financial services sector - that between banking and insurance<sup>88</sup>. Encouraged by the increasing popularity of mutual funds as savings vehicles (and by structural deregulation policies), insurers increasingly entered the asset management industry and set up their own capital market divisions. Banks for their part became increasingly interested in the insurance market as improved information technology systems opened up new possibilities of cross-selling insurance services through banks' branch networks, e.g. offering home insurance products to mortgage owners<sup>89</sup>.

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<sup>83</sup> The key difference between finance raised from capital markets and loans provided by banks is that capital markets cut out the middlemen (hence “disintermediation”). While in the traditional loan business, banks stand between savers and investors, directing the flow of resources, capital markets bring the two parties face to face and thereby promote an efficient allocation of capital. See Büschgen (1992), p. 34.

<sup>84</sup> Kono has noted that the value of securities issues increased from about US\$ 100bn in 1987 to over US\$ 500bn in 1996. See Kono (1997), p. 10.

<sup>85</sup> Edey and Hvding (1995) reported that banks have started making more money from securities trade relative to traditional bank credits.

<sup>86</sup> See for example Büschgen (1989), p. 6 and Schmitz (1991).

<sup>87</sup> Derivatives transactions, for example, have over the last decade increased more than ten-fold. At the end of 1996, outstanding futures and options in interest rates, currencies and stock market indices amounted to US\$ 10 trillion. This amounted to almost twice the total value of world trade in 1996. In the same year the value of outstanding swaps and swap-related derivatives reached US\$ 25 trillion. See BIS (1997).

<sup>88</sup> See Mühlemann (1998).

<sup>89</sup> All of the six banks also diversified into the insurance sector, albeit only on a national scale. Deutsche Bank, for example, established a co-operation with Deutscher Herold, Dresdner Bank with Allianz and

In short, as the markets for all kinds of different financial services became more integrated and banks began to lose their traditional role as intermediary between savers and borrowers as a result of securitisation, all six banks began to broaden and re-focus their business portfolios. One Swiss executive remarked that

“the underlying rationale for this strategy is the belief that the future belongs to the diversified financial conglomerate with its ability to meet all of its customers’ needs”<sup>90</sup>.

Having reviewed sectoral developments in the financial services sector and analysed the business focus of the six banks, the study can now move on to analyse their internationalisation processes.

### **The Three German Banks: Deutsche Bank, Dresdner Bank and Commerzbank**

Unlike the three German pharmaceutical MNEs, the three banks do not share a history of long internationalisation. In fact, it seems fair to argue that by the mid-1980s – the starting point of this study – the German banks were hardly internationalised at all. International business activities were limited and largely confined to basic commercial banking activities (i.e. loans and project financing) carried out from headquarters in Germany. Internationally expanding corporate customers were provided with rudimentary financial services in selected host countries, mostly through representation offices or co-operation arrangements with foreign banks. Often this reluctance to internationalise business activities is explained by psychological reasons: all three banks had lost their entire international operations twice within only a few decades - after World War One and Two - and thus approached internationalisation with extreme care<sup>91</sup>. However, as a response to the challenges analysed above, internationalisation got slowly under way during the 1980s and strongly accelerated during the 1990s.

Deutsche Bank has been without doubt the most the most aggressive “internationaliser” of the German trio. In terms of pace, scale and scope, its internationalisation process has clearly been in a class of its own when compared to that of Dresdner Bank and Commerzbank.

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UBS with the Swiss Rentenanstalt. Credit Suisse went a step further and acquired in 1997 Winterthur, a leading Swiss insurer.

<sup>90</sup> Interview.

In order to quickly build up a substantial securities business, Deutsche pushed during the second half of the 1980s aggressively into investment banking and asset management<sup>92</sup>. Apart from acquiring medium-sized securities houses in Austria and the Netherlands in the late 1980s<sup>93</sup>, the most significant step in this strategy was Deutsche's acquisition of the British Morgan Grenfell Group in 1990, a highly internationalised securities house with branches and sister companies in more than 20 countries. It was Deutsche's largest post-war investment and turned it literally overnight into a major global force in investment banking and asset management<sup>94</sup>. Also during the late 1980s, Deutsche established a large presence in Asia with two newly set up sister companies in Hong Kong and Singapore and a greatly expanded presence in Tokyo<sup>95</sup>. However, it was not Asia or Europe where Deutsche Bank concentrated its internationalisation and expansion efforts, but the US. Until the mid-90s, Deutsche Bank concentrated its efforts largely on trying to penetrate the US market, the world's largest market for investment banking and asset management, and at best simultaneously expanded its European operations. Schmitz has remarked that

"in the years from 1990 to 1994, we [the management board] talked eight times about North America before we talked one time about Europe. At that stage, we were probably devoting more executive time to North America than we were to Europe".<sup>96</sup>

However, Deutsche Bank did not buy a major American bank until 1998 but rather relied on organic growth. In 1990, Deutsche Bank North America had estimated assets of about \$3.5bn, revenues of around \$200 and employed 300-350 people. By 1997, Deutsche had 4500 employees, assets of \$80bn and revenues of \$1.2bn<sup>97</sup>. Starting in mid-1990s, however, Deutsche Bank re-shifted its focus somewhat more towards the European market. As Schmitz has put it,

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<sup>91</sup> See Büschgen (1995), p. 725.

<sup>92</sup> It is often argued that there are important synergies between these two businesses: a strong position in asset management increases a banks' placing power of newly issued equity and asset management, in turn, benefits from privileged access to investment banking products.

<sup>93</sup> In 1988 Deutsche acquired H.Albert de Bary, Amsterdam and in 1989 it acquired Antoni, Hacker & Co, Vienna. See Büschgen (1995), pp. 845f.

<sup>94</sup> Ibid., p. 788.

<sup>95</sup> See "Die Deutsche Bank im Angriff", *Bilanz* 2/1997, pp. 40-45.

<sup>96</sup> See "New role for US as Europe moves to centre stage", Interview with Ronaldo Schmitz in *Financial Times*, May 13 1998.

"The emergence of a monetarily unified Europe has created new perspectives in this bank that have to be addressed .....It took us quite some time to understand what the euro would mean."<sup>98</sup>.

While clearly being a global force in the securities business, Deutsche has, however, still not managed to enter the premier league of global investment banks, the so-called "bulge bracket". In global M&A advice, one of the most lucrative bits of the investment banking business, Deutsche Bank is not among the world's top ten banks, and even in its European "home market" its market share amounted to only 5.5 per cent in 1998<sup>99</sup>.

In contrast to investment banking and asset management, Deutsche Bank did not seek to become a global force in commercial banking and expanded these services only selectively to the economically most important regions. However, in contrast to the other five banks, Deutsche Bank offers retail banking services abroad, albeit only in two countries. Through acquiring Banca d'America e d'Italia (BAI) in Italy, and Banco Comercial Transatlantico and Banco do Madrid in Spain, Deutsche Bank entered the retail market in these two countries<sup>100</sup>.

Dresdner Bank, took a markedly more careful approach towards expanding and internationalising its business activities. The most significant steps occurred in 1995 with the acquisition of the British merchant bank Kleinwort Benson and the New York-based fund manager RCM. Before that, Dresdner relied in the US on its two securities vehicles ABD securities and ABDI fund managing, set up in the mid-1980s. In Europe, Dresdner Bank established sister companies in Luxembourg and Ireland and acquired in 1992 a majority stake in the medium-sized British merchant bank Thornton. In Asia, Dresdner Bank is represented mainly through the branches of Thornton (and later of Kleinwort Benson)<sup>101</sup>. While considerably strong in asset management, Dresdner does not come close to Deutsche Bank in international capital market prowess<sup>102</sup>. Nevertheless it managed to build up an

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<sup>97</sup> Ibid.

<sup>98</sup> Ibid.

<sup>99</sup> See "Top 10 investment banks take 77% of market", *Financial Times*, March 1 1999.

<sup>100</sup> Between 1988 and 1992 Deutsche Bank raised its stake in BCT from 39 per cent to 97 per cent. See Büschgen (1995), p. 845. See also "Der lange Weg zur Europa-Bank", *Frankfurter Allgemeine Zeitung*, July 23 1991.

<sup>101</sup> See "Individual Approaches to the same goal", *Financial Times*, Oct. 30 1989; "Dresdner Bank: beavering away at building a reputation on the quiet", *Financial Times*, Aug. 24 1988 and "Die Dresdner Bank verfolgt für Europa Strategie der Selektion", *Börsenzeitung*, Nov. 3 1989.

<sup>102</sup> See "Die stärksten Investmentbanken der Welt", *Frankfurter Allgemeine Zeitung*, Oct. 7 1994 and "Mangelnde Koordination", *Wirtschaftswoche*, Feb. 29 1996.

international network of sister companies in investment banking and asset management that covers the triad economies and offers the full range of investment services and products<sup>103</sup>.

With regard to commercial banking activities, Dresdner's approach is significantly more low key and selective than that of Deutsche Bank and is centred on co-operation arrangements with foreign banks – the most significant one being with Banque Nationale de Paris (BNP), signed in 1991<sup>104</sup>.

Commerzbank, the smallest of the three German banks, is significantly less internationalised than Deutsche Bank and Dresdner Bank. Compared to the latter two, Commerzbank's investment banking activities lag considerably. By 1995, corporate finance activities were still largely limited to the home market and the focus of its securities business continued to be almost exclusively on German titles<sup>105</sup>. For asset management, Commerzbank established sister companies in Luxembourg, Singapore, Tokyo and New York. In 1995, however, Commerzbank somewhat stepped up its international expansion with the acquisition of a French (CCR) and British (Jupiter International) asset management group<sup>106</sup>. Additionally it started to build up investment banking capacities through a sister company headquartered in Frankfurt (Commercial Financial products) with branches in London, New York, Paris and Tokyo. However, despite this recent expansion, Commerzbank's chairman Martin Kohlhaussen has made it clear that control over business operations will remain in Frankfurt<sup>107</sup>.

With regard to commercial banking, Commerzbank relies heavily on a number of cooperation arrangements with foreign banks. Until 1991, this strategy centred around the *EuroPartners Group* through which a number of European banks (i.e. Credit Lyonnais, Banco Hispano Americano) pooled organisational resources. However, in 1992 this loose grouping of banks broke up and Commerzbank established a patchwork of strategic partnerships with other European banks for specific business activities, e.g. a partnership for cross-border payments with NatWest and Société Générale<sup>108</sup>.

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<sup>103</sup> See "Dresdner Bank Investment Services in a New Europe", *Euromoney*, September 1990.

<sup>104</sup> See "Dresdner Bank setzt auf Kooperationen", *Börsenzeitung*, Dec. 7 1991.

<sup>105</sup> See "Es gibt keine Übernahmekandidaten", *Börsenzeitung*, March 27 1996.

<sup>106</sup> See "Die Commerzbank will ihr Geschäft im Ausland verstärken", *Frankfurter Allgemeine Zeitung*, March 31 1995.

<sup>107</sup> See "Es muss nicht immer London sein", Commerzbank's chairman Martin Kohlhaussen in *Börsenzeitung* April 27 1996.

<sup>108</sup> See "Intensiv Kooperieren", Interview with Kohlhaussen in *Wirtschafts Woche*, Feb. 22 1996. See also "Die sperrigen Europartner", *Frankfurter Allgemeine Zeitung*, June 21 1991 and "Das Standing der Commerzbank", *Börsenzeitung*, Feb. 17 1995.

## The Three Swiss Banks: Credit Suisse, Swiss Bank Corporation and Union Bank of Switzerland

Although the three Swiss banks were by the mid-1980s more internationalised than the German banks, they were – with the notable exception of Credit Suisse – just as reluctant as their German counterparts to respond to the challenges that were facing the financial services industry during the last two decades. In fact, similar to the German banks, major strategic moves did not occur before the late 1980s and early 1990s. Establishing which of the Swiss banks internationalised most rapidly and extensively is not as clear-cut as in the German case. Certainly Credit Suisse was the pioneer, but during the 1990s, SBC was clearly the most acquisitive of the three banks – a strategy that culminated in the 1997 merger with UBS, its larger Swiss rival, which was often seen as a take-over in disguise. UBS, in contrast, was clearly the slowest of the three banks to expand internationally.

Credit Suisse began building up investment banking capacities in 1978 through a partnership with the American investment bank First Boston, which manifested itself in a jointly set up sister company (Credit Suisse First Boston) that rapidly built up an international network of subsidiaries covering the triad economies. Asset management capacities were added in the mid-1980s through additional subsidiaries in New York, London and Tokyo. In 1989, Credit Suisse First Boston acquired the British brokerage house Buckmaster & Moore and in 1990, it acquired a majority stake in BEEA Associates<sup>109</sup>. In 1988, the joint venture with First Boston was put on a new organisational footing as Credit Suisse turned itself into CS Holding and increased its stake in First Boston, first to 44.5 per cent and one year later to 60 per cent - an important step in Credit Suisse's internationalisation process, which in the words of chairman Rainer Gut, "effectively established a Swiss universal bank and globally operating investment bank under the control of CS Holding"<sup>110</sup>.

The next major step in Credit Suisse's internationalisation process occurred in 1996 with the internal restructuring that established the Credit Suisse Group and resulted in four clearly separated business divisions. Two of these four divisions - Credit Suisse First Boston and Credit Suisse Asset Management - are headquartered in London and New York and can be

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<sup>109</sup> See Annual Report 1990, pp.27-28 and "Flucht ins Ausland", *Bilanz* 2/90, pp. 52-59.

<sup>110</sup> See "Mit der CS Holding in eine faszinierende Zukunft", Rainer Gut in *SKA Bulletin* April 1989 p. 6-11. See also "Kontrolle der CS Holding über First Boston", *Neue Zürcher Zeitung*, Nov. 14 1990.

regarded as globalised<sup>111</sup>. The other two - Credit Suisse and Credit Suisse Private Banking - continue to be run from group headquarters in Zurich.

Of all the selected banks, Credit Suisse has by a significant margin the largest investment banking business. With Credit Suisse First Boston it owns an investment bank that is generally considered to be among the world's largest, though not in the same league with Merrill Lynch, Goldman Sachs and Morgan Stanley Dean Witter – the “bulge bracket”. In 1998, CSFB was the world's 5<sup>th</sup> largest advisor on M&As with a global market share of almost 14 per cent<sup>112</sup>. In contrast, Credit Suisse's commercial banking activities are a lot less internationalised. Not only do they continue to be run from Zurich, but their internationalisation was also confined to single branches in economically important regions.

Swiss Bank Corporation (SBC) began to tentatively internationalise business activities during the 1980s with the establishment of an investment banking subsidiary in London (SBCI), which quickly set up off-shoots in the major international financial centres. In 1987, SBC acquired the British brokerage house Savory Milln. Asset management began to be internationalised in 1983 with the establishment of a sister company in New York, followed by sister companies in Frankfurt, London and Dublin (all in 1987). In response to the single market, SBC set up corporate finance units in the Netherlands, Italy and Spain geared towards providing M&A advisory services<sup>113</sup>. These initiatives were, however, dwarfed by a number of acquisitions during the first half of the 1990s. In 1991, SBC acquired the Chicago-based derivatives firm O'Connor & Associates and in 1995 the US fund manager Brinson Partners and the corporate finance and equities business of S.G.Warburg, a leading British merchant bank. The scale of these last two transactions had a visible effect on SBC's balance sheet: it grew from SFr. 212bn in 1994 to SFr. 360bn in 1996<sup>114</sup>. In contrast to the securities business, SBC did not aspire to become a global player in commercial banking activities and internationalisation in this business segment remained limited and confined to single branches in economically important countries.

In 1995, SBC restructured its business operations into four clearly divided and largely independent business divisions - a move that was a year later copied by Credit Suisse (see above). Similar to Credit Suisse, SBC's investment banking and asset management divisions are headquartered outside Switzerland (in London and Chicago) and operate on a global basis, while commercial and private banking activities continue to be run from headquarters

<sup>111</sup> Interviews. See also “Big Shake-Up at Credit Suisse”, *Financial Times*, July 3 1996.

<sup>112</sup> See “Top 10 investment banks take 77% of market”, *Financial Times*, March 1 1999.

<sup>113</sup> See “Flucht ins Ausland”, *Bilanz* 2/90, pp. 52-59.

in Basle. One executive remarked that "Swiss Bank Corporation can be thought of as a Swiss holding company consisting of two Swiss, one British and one American bank".

Compared to its two Swiss rivals, the internationalisation process of UBS was significantly more low-key, and focused on establishing substantial presences in London, New York and Tokyo - the world's major financial centres. In London, UBS expanded its presence in 1985 by acquiring a stake in the British brokerage house Philips & Drew, which led to a full take-over in 1989<sup>115</sup>. In New York, UBS acquired in 1991 the fund manager Chase Investors Management, subsequently re-named UBS Asset Management Inc<sup>116</sup>. In Tokyo, UBS relied on organic growth. While UBS was generally regarded to be less internationalised than Credit Suisse or SBC, it was still considered to be global force in investment banking and asset management<sup>117</sup>. Similar to its two Swiss rivals, UBS showed no ambitions to significantly internationalise its commercial banking activities.

### **The Extent and Nature of the Six Banks' Internationalisation Process**

Although the internationalisation process in the financial services industry started in the 1960s and greatly increased during the 1970s and 1980s when new financial instruments and structural deregulation policies established a worldwide market for financial services, the six German and Swiss banks were latecomers to this development and – with the exception of Credit Suisse - were by the mid-1980s considerably less internationalised than their American and Japanese counterparts. Since the late 1980s and early 1990s, however, both the three German and the three Swiss banks made strong strategic moves to become major European and global players. However, unlike as in the pharmaceutical sector, the six banks' internationalisation processes were very selective. It was shown that none of the selected banks embarked on an "across-the-board" internationalisation of its complete service range.

In commercial banking, Deutsche Bank, Credit Suisse, SBC and UBS limited their internationalisation strategies to setting up single branches in the major cities of economically important regions – mostly the triad economies. Dresdner Bank and Commerzbank did not even go that far and continued to rely on co-operation arrangements with foreign banks.

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<sup>114</sup> Annual Report 1997.

<sup>115</sup> See "Flucht ins Ausland", *Bilanz*, 2/90, pp. 52-59.

<sup>116</sup> See "UBS snaps up Chase Investors", *Global Investor* 1991.

Moreover, internationalisation in this sub-sector was confined to services for corporate customers<sup>118</sup>. Except for Deutsche Bank, none of the selected banks showed any enthusiasm for internationalising their retail banking activities, and even Deutsche Bank explicitly stated that its purchase of retail banks in Italy and Spain were “one-off” acquisitions, rather than first steps towards an international branch network<sup>119</sup>. It should also be pointed out that internationalisation in this sub-sector was largely defensive, in the sense that the primary objective was not to gain new customers, but rather not to lose old ones – the internationally expanding corporate clients from banks’ home countries, which began to demand increasingly sophisticated financial services in host countries<sup>120</sup>.

For the internationalisation of investment banking and asset management activities the opposite was true. Here banks’ internationalisation strategies were everything but defensive. As was shown in the previous section, all of the selected banks, except Commerzbank, made major strategic moves to expand and internationalise these two businesses, and all efforts were geared towards winning new and international customers. In the words of one interviewee,

“all of the selected banks (with the exception of Commerzbank) transformed themselves from universal banks into international investment banks with a substantial domestic commercial business on the side”<sup>121</sup>.

Supporting this analysis with numbers is, however, difficult. Banks’ do not publish detailed data about the geographical spread of their loan portfolios or their market share in foreign countries. Moreover, their annual reports still do not explicitly distinguish between their domestic and international business, or between on-balance and off-balance sheet activities<sup>122</sup>. Due to the absence of such data, this study was left with comparing the number

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<sup>117</sup> See “Deutsche Bank – Schweizerische Bankgesellschaft: Die Deutsche Bank im Angriff”, *Bilanz* 2/1997, pp. 40-45. In 1993, the *Basler Zeitung* estimated that UBS will soon earn every second franc abroad. See *Basler Zeitung*, Aug. 13 1993.

<sup>118</sup> See for example “Der lange Weg zur Europa-Bank”, *Frankfurter Allgemeine Zeitung*, July 23 1991.

<sup>119</sup> As Deutsche Bank’s former chairman Hilmar Kopper has put it, “...it is completely unrealistic that Deutsche Bank will become a worldwide universal bank offering its whole domestic service range abroad”. Interview with Hilmar Kopper in *Industriemagazin* Nr. 2 1991 pp. 25-28. See also “Insel der Seeligen” Interview with Kopper in *Wirtschaftswoche* 44 (1990), Nr. 39, pp. 226-230.

<sup>120</sup> See “Wir verlagern nicht ins Ausland – wir folgen unseren Kunden” Interview with Credit Suisse’s former board president Robert Jeker in *Badener Tagblatt*, July 25 1992. See also Schmitz (1991).

<sup>121</sup> See also *UBS International Finance*, Winter 1991, pp. 2-4.

<sup>122</sup> See Krueger (1989), p. 320. See also Annual Report 1989 by the Swiss Association for Financial Analysis, quoted in “Information der Banken: Konsolidierung als Ziel”, *Schweizerische Handelszeitung*, Feb. 22 1990.

of the six banks' foreign subsidiaries and employees abroad (see table 2.8). Clearly, however, this data is not sufficient to make predictions about banks' trade policy preferences. Nevertheless by drawing on sectoral characteristics it should be possible to judge whether the six banks' international business was significant enough to give them a strong interest in open international markets<sup>123</sup>.

	Foreign Branches And Subsidiaries	Employees Abroad	% of total Employees
Deutsche Bank	803 (66)	22.162 (3.759)	29.9 (7.7)
Dresdner Bank	54 (34)	6.385 (666)	13.6 (2.0)
Commerzbank	50 (33)	2.174 (732)	7.3 (3.0)
Credit Suisse	106 (47)	4.611 (1.062)	17.6 (8.3)
SBC	76 (52)	9.154 (1.877)	33.6 (12.6)
UBS	69 (40)	7.101 (905)	24.4 (4.8)

Table 2.8: Figures relating to the Six Banks' Internationalisation Processes (1995). 1985 Figures in Brackets.

Source: Annual Reports, own calculations.

In commercial banking, as executives from the six banks pointed out, sectoral characteristics discouraged banks from internationalising business activities on a scale comparable to that of the securities business<sup>124</sup>. Two characteristics specific to banks' lending and retail business were mentioned. First, commercial banking services are generally what Bodewyn, Halbrich and Pery have called "location-bound services": they are usually specialised activities that are tailored to the specific needs of the client and therefore require familiarity with particular locations, which – bottom line – makes the scope for global products very small<sup>125</sup>. Moreover, commercial banking services are often plagued by what Hirsch has called "the factor of simultaneity" – the need for the simultaneous interaction of producer and

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Karsenty and Mattoo (1997) have pointed out that given the fundamental importance of financial service the current lack of reliable and detailed data was remarkable.

<sup>123</sup> Kono, for example, has pointed out that the growing importance of commercial presence in foreign markets via subsidiaries, branch offices, or equity participation can be inferred to some extent from other indicators, without specific data on the modes of supply. See Kono (1997), p. 16.

<sup>124</sup> Interviews.

<sup>125</sup> See Bodewyn, Halbrich and Pery (1986).

consumer<sup>126</sup>. Taken together, these characteristics act as a trade-retarding element and imply that foreign markets can only be served through branch networks – an investment, which involves substantial sunk costs and thus put limits on the extent to which banks were willing to internationalise these services<sup>127</sup>.

Second, in contrast to investment banking and asset management, banks' lending and retail business are characterised by significant natural barriers to entry. One German executive commented that "when it comes to commercial banking activities, price competition is virtually absent"<sup>128</sup>. Another executive conceded that "applications for business loans, in Germany and abroad, tend not to be looked at solely in economic terms"<sup>129</sup>. In other words, this sub-sector is characterised by highly personalised business relationships. As a result, it is generally held that indigenous banks have an inherent competitive advantage that makes it difficult for foreign banks to penetrate these markets<sup>130</sup>. In investment banking and asset management the picture almost reverses itself. First, fierce price competition makes these markets relatively contestable. In the words of one executive, "investment banking is about deals, not clients"<sup>131</sup>.

Second, these two sub-sectors can be relatively easily internationalised since the important bits of the investment banking and asset management business are highly concentrated – or clustered – in a few financial centres, mainly London, New York and Tokyo, and corporate customers travel to these centres for their business transactions<sup>132</sup>. As a result, the selected banks were able to internationalise, or even globalise, their business activities in these two sub-sectors with only a handful of international subsidiaries since, as Hanselmann has put it, "market proximity is more important than customer proximity"<sup>133</sup>.

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<sup>126</sup> See Hirsch (1987).

<sup>127</sup> Interviews

<sup>128</sup> Interview.

<sup>129</sup> Interview.

<sup>130</sup> See Gut (1989), Krumnow (1989) and Campayne (1992a).

<sup>131</sup> Interview.

<sup>132</sup> Analysing the locational choices of 61 multinational banks, Campayne (1992b) found that global investment banking and asset management activities tended to be highly concentrated. Essentially these businesses are clustered in a few financial centres for the same reason that the film industry is clustered in Hollywood and high technology industries in Silicon Valley: clusters create innovative – and therefore competitive – businesses. According to Michael Porter (1990), innovation is sparked partly through close working relationships with suppliers and rivalries with competitors, which are sharper if businesses are physically close to each other. For investment banks these suppliers are lawyers, accountants and management consultants and clusters make it not only easier to coordinate them, but also to transfer skills and ideas: in New York investment banks routinely poach credit analysts from their rating agency neighbours and in London investment banks' corporate finance divisions often recruit staff from the City's law firms. See "Capitals of capital", *The Economist*, May 9 1998

<sup>133</sup> Hanselmann (1990), p. 62.

Moreover, unlike in commercial banking, not all of the securities business is "location-bound". In fact, some financial services - e.g. bond sales - generate a product separable from the production process that can then be transferred across national boundaries by means of communications technology. Other services, such as financial futures and traded options, are only partly location-bound, while the other part of the process is tradable<sup>134</sup>. Hence these services were relatively easy to internationalise since banks could use their presences in financial centres as export platforms<sup>135</sup>.

With regard to the nature of the six banks' internationalisation process, one has again to distinguish between commercial banking on the one hand, and investment banking and asset management on the other. In commercial banking the case was relatively straightforward. At all six banks, internationalisation was essentially a case of conducting international operations from the home country and supplying services through outlets abroad – either through branches or co-operation arrangements with foreign banks<sup>136</sup>. In Bartlett and Goshal's terminology, this modus operandi corresponded to their concept of an *international company* - a company characterised "by a focus on its home market with exports as a necessary appendage and whose strategy is based primarily on transferring and adapting the parent company's knowledge and expertise to foreign markets"<sup>137</sup>.

This concept was also characteristic of the Swiss banks' private banking business, in the sense that the Swiss banks used their long expertise in this sub-sector to service affluent foreign customers who travel to Switzerland for their financial transactions. However, the Swiss banks' private banking business is far from being just a "necessary appendage", but rather a core business, often referred to as the "jewel in the crown". While annual reports of banks have hitherto provided only scanty information about assets under management, it is estimated that Switzerland's share of the international portfolio management business with private customers amounts to as much as 35 per cent<sup>138</sup>. Blattner has estimated that portfolio management accounts for almost 40 per cent of employment in the banking sector and accounts for 23 per cent of Switzerland's total export surplus<sup>139</sup>.

In investment banking and asset management the picture was less clear cut. At first sight there appeared to be significant differences between the six banks. It was pointed out that Credit Suisse and SBC turned themselves into holding companies while the others preferred

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<sup>134</sup> See Boddewyn, Halbrich and Perry (1986).

<sup>135</sup> Interviews.

<sup>136</sup> Interviews.

<sup>137</sup> Bartlett and Goshal (1989), p. 14.

<sup>138</sup> See Swiss Bankers Association Annual Report 1996, p. 33.

an integrated approach. However, when one rises beyond these labels one finds a lot of similarities. Essentially all banks used two models to structure their businesses in these two sub-sectors. One executive likened the first model to the hub and spokes of a wheel. Hub activities included strategic planning, product development, project management and trading and all of the selected banks (except Commerzbank) concentrated these activities either in London or New York, since cluster effects favoured their physical concentration. Spoke activities – usually sales, marketing and company analysis – keep the business in touch with customers and good information and were thus decentralised away from financial centres<sup>140</sup>.

In parallel, however, banks employed a second model that used cost as its organising principle. In the words of one executive,

“concentrating businesses in financial centres is expensive and not all activities necessarily benefit from cluster effects. For example, M&A work requires close personal negotiations between a company, its bankers and its lawyers, so it is clearly best done in financial centres. The same is true for the business of raising capital for companies and governments, such as floating initial public offerings (IPOs) and new bond issues”<sup>141</sup>.

On the other hand, however, administrative tasks, such as clearing and settling trades or handling a company’s cash payments can be done anywhere, and banks have moved these activities out of financial centres<sup>142</sup>.

As a result of these complexities, banks’ investment banking and asset management business did not fit neatly into Bartlett and Goshal’s typology: the strategy of using financial centres as export platforms had elements of their *global company*, which “centralises a company’s business activities in a few locations and seeks to standardise products and production processes in order to increase efficiency”<sup>143</sup>. The hub and spoke approach, on the other hand, had elements of Bartlett and Goshal’s *integrated production networks*, in which sister companies or subsidiaries do not play uniform roles, but rather according to the importance of their contribution to operations<sup>144</sup>.

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<sup>139</sup> See Blattner (1996).

<sup>140</sup> Interviews. See also Bumbacher (1993) and “Über die Zeitalter im Banking”, *Börsenzeitung*, Feb. 16 1995. For the need to devise an international division of labour among subsidiaries see Krueger (1989), p. 325 and Sarrazin (1987), p. 273.

<sup>141</sup> Interview.

<sup>142</sup> Interviews.

<sup>143</sup> Bartlett and Goshal (1989), p. 51.

<sup>144</sup> Ibid., p. 60.

To be sure, similar to the six pharmaceutical MNEs, the process of devising an international division of labour among subsidiaries is not equally advanced at all six banks. Certainly Commerzbank lagged considerably when it came to shifting managerial responsibilities abroad. With respect to the other five banks, interviewees frequently argued that UBS and Dresdner Bank had been more reluctant than Credit Suisse, SBC and Deutsche Bank to decentralise decision-making authority to foreign offshoots. Having said that, however, it appears unlikely that these differences should become visible in the six banks' trade policy preferences. As a result of the concentration of the securities business in a few financial centres, all six banks can be expected to have a strong interest in open international markets. Even if a bank's securities business is largely focused on the home market (as in the case of Commerzbank) the bank can still be expected to favour open international markets, since the securities business is best carried out in an international financial centre and thus requires as a prerequisite an open international financial system<sup>145</sup>.

## Conclusion

This chapter has analysed the business focus and internationalisation processes of the selected 12 MNEs as a first step towards examining their economic policy preferences. With regard to the MNEs' business focus, it was noted that in both sectors the selected MNEs pursued broadly similar objectives. In the pharmaceutical sector it was shown that all six MNEs were highly research-intensive firms with a strong focus on the development of innovative drugs. In the financial services sector, all banks, with the exception of Germany's Commerzbank, responded to the structural changes sweeping through the financial services industry by turning themselves into international investment banks with a substantial domestic business on the side. During the second half of the 1990s, Commerzbank also increasingly expanded its securities business.

With regard to the extent and nature of the 12 MNEs' internationalisation process, there have been significant differences between the two sectors. First, while the six pharmaceutical MNEs all share a long history of multinational investment and were already highly internationalised by the mid-1980s, the six banks were much less so. In fact, in the mid-1980s, the German banks were hardly internationalised at all. Although the Swiss banks were

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<sup>145</sup> Interviews.

also strongly focused on their domestic market, they were able to do a substantial amount of international business from Switzerland due to the attractiveness of Switzerland as a financial centre. However, when it came to expanding abroad, the Swiss banks were as reluctant as the German banks.

Second, it was shown that although all six banks have taken important steps during the last decade to internationalise their business activities, these processes were a lot more selective than those of the six pharmaceutical MNEs. In fact, the six banks only took decisive steps to internationalise their investment banking and asset management business while commercial banking activities remained primarily focused on the home market. In contrast, the six pharmaceutical MNEs not only further increased their foreign sales, but also started to internationalise high value-added production and R&D activities, which had hitherto been largely concentrated in their home countries.

Does this then mean that the six banks can be expected to be less supportive of free trade than the six pharmaceutical MNEs? On the basis of this analysis, this appears to be unlikely, at least when it comes to the six banks' investment banking and asset management operations. Given that a significant amount of this business is highly concentrated in a relatively small number of international financial centres, the six banks can be expected to have a strong interest in an open international financial system that allows them to do business across national jurisdictions, even if their domestic business operations continue to be large. With regard to banks commercial banking activities the picture is, however, less clear. With the exception of Deutsche Bank, none of the six banks took decisive steps to internationalise this business segment, and hence it remains an open question whether the banks have a strong interest in promoting open international markets in this sub-sector.

# 3

## **Economic Policy Preferences of the Six Pharmaceutical MNEs and the Six Banks**

Chapter 2 has analysed the business focus and internationalisation processes of the six German and Swiss pharmaceutical MNEs and banks. The purpose of this chapter is now to explain how these factors have interacted with sectoral characteristics to shape the preferences of the 12 MNEs with regard to the selected policy issues.

Chapter 1 has pointed out that policy preferences can be price mechanism promoting, distorting or suspending. It was argued that while the literature on these three types of preferences was quite extensive, there were comparatively few attempts that sought to link these preferences to MNEs. So far, the most notable efforts were made within the context of trade policy. These studies led to the finding, most eloquently expressed by Milner, that MNEs' trade policy preferences could be explained as the result of the extent and nature of their internationalisation processes<sup>1</sup>. This study has no quarrel with this finding as far as it goes. The argument here is merely that it does not go very far if one seeks to analyse MNEs' preferences with regard to price competition in more general terms. Clearly, the functioning of competition is not only affected by trade policies, but also by a whole range of domestic policy issues. It was argued that broadening the analysis to include such policies requires, however, two additional explanatory factors: *MNEs' business focus* and *sectoral characteristics*. This chapter will now examine this hypothesis. Building on the analysis of the previous chapter, the following sections will examine how MNEs' internationalisation processes and business focus have interacted with sectoral characteristics to shape the economic policy preferences of the six pharmaceutical MNEs and banks.

## The Six German and Swiss Pharmaceutical MNEs

Trade in the German and Swiss pharmaceutical sector is largely free, in the sense that there are no significant border restrictions preventing or distorting the flow of pharmaceuticals across national boundaries. This does, however, not mean that an undistorted price mechanism matches supply and demand in the sector. In fact, the price mechanism in the pharmaceutical sector is strongly affected by a number of domestic policies: intellectual property rights, health care policies, regulations for products derived from the application of biotechnology and, in the German case, drug re-imports from other European countries where governments keep drug prices artificially lower than in Germany (the so-called parallel imports). While certainly domestic in nature, three of those four issue areas have acquired an international dimension in recent years. Most clearly this has been the case with intellectual property rights as witnessed by the TRIPs (Trade Related Aspects of Intellectual Property Rights) agreement of the Uruguay Round of the GATT. However, biotechnology regulations have also already sparked transatlantic rows<sup>2</sup> and parallel imports have emerged as a serious problem within trading blocs. Only health care policies have remained a purely national policy issue. The following sections will now analyse the six MNEs' policy preferences with regard to these four policy issues and examine the extent to which they can be explained by MNEs' internationalisation process, their business focus and sectoral characteristics.

### Intellectual Property Rights

The protection of intellectual property is of crucial importance for the six MNEs. In the words of one executive, "intellectual property rights are the actual capital of pharmaceutical companies"<sup>3</sup>. This is hardly surprising. The previous chapter has pointed out that it takes on average 12 years to develop a new drug and costs about \$500m. Moreover, unlike as in the electronics or car sector, drugs can be easily split into their components and put together

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<sup>1</sup> See Milner (1988).

<sup>2</sup> Fears about future trade conflicts were, for example, voiced by Stuart Eizenstat who complained about the unwillingness of the EU to analyse biotechnology products on the basis of scientific evidence available, as is required by the WTO. In his view European procedures for the testing and approving of biotechnology products often involve a long search for the "right" scientific evidence to support a political prejudice. See "Why we should welcome biotechnology", *Financial Times*, April 16 1999. See also Chapter 7.

<sup>3</sup> Interview.

again - in other words, they can be easily replicated<sup>4</sup>. All interviewed executives linked their preference for "state of the art" intellectual property protection to these sector-specific characteristics. As an executive from *Interpharma*, the association grouping the pharmaceutical divisions of the Swiss MNEs, argued, "intellectual property rights are absolutely essential to recover the enormous costs for the development of new drugs"<sup>5</sup>. Moreover, all interviewees strongly advocated the harmonisation of patent laws on a global scale. A Hoechst executive pointed out that

"the immense costs of R&D can be recovered only if there is a limited but reasonable period of patent protection. Thus far, many countries have insufficient patent laws with no protection for new products, with the consequence that local companies make use of the most successful inventions made in other countries by counterfeiting and without investing in R&D.....The business community desires far-reaching harmonisation of patent laws, as world business is impeded by significant differences between national patent laws"<sup>6</sup>.

While sectoral characteristics were clearly the most important factor behind MNEs' preferences in this policy area, business focus and internationalisation were also significant. Chapter 2 has pointed out that all six MNEs strongly focused on research-intensive drugs. It appears unlikely that a business focus on generic drugs would have given them an equally strong interest in the protection of intellectual property. Moreover, the high exposure of the six MNEs to foreign markets has clearly also been a factor behind their preference for worldwide protection of intellectual property<sup>7</sup>.

Judging whether this preference for a maximum of intellectual property protection and worldwide harmonisation of patent laws is competition promoting, distorting or suspending is, however, difficult. Several factors need to be considered. On the one hand, it could be argued that by permitting the innovator to bar imitators, patent protection conveys potential monopoly power for the duration of the patent. Seen from this perspective, the preference for

<sup>4</sup> See Zweifel (1982), pp. 45ff and Wartenweiler (1988), p. 37.

<sup>5</sup> Interview. For a similar view see Humer (1997), *SGCI* Annual Report (1989), pp. 23f and VFA (1997).

<sup>6</sup> See Schulze-Steinen (1996), p. 52. For a similar view see VFA Annual Report (1996), p. 16 and *Interpharma* (1990). Trebilcock and Howse have pointed out that many developing countries, including some NICs, have often afforded a shorter period of patent protection (and in some cases more narrowly defined protection) to products such as pharmaceuticals than do the US and Europe. In addition, the patent granting process and the enforcement of patent protection in many developing countries has been viewed as lacking in transparency and legal security. See Trebilcock and Howse (1999), p. 307.

intellectual property protection can be regarded as rent-seeking behaviour. On the other hand, however, it is argued that functioning markets require this kind of protection. Arrow has pointed out that in the absence of patent protection, the market would underinvest in the production of new knowledge, because imitators could immediately copy new inventions. Competition would force prices down to marginal production costs and the innovator could not recover the costs of R&D. By granting innovators the exclusive rights to commercialise their intellectual assets over a certain period of time, intellectual property rights offer an incentive for the production of knowledge<sup>8</sup>. In fact, most industrialised countries grant patent protection as a means of recognising the legitimate claim of innovators to receive a reasonable return on their R&D investments<sup>9</sup>.

However, even if one accepts the need for patent protection in principle, one still needs to consider the actual length of protection periods (currently 20 years). Judging whether this period is adequate, is difficult. Danzon has pointed out that "whether or not actual patent duration is adequate, excessive or insufficient to encourage an optimal rate of innovation is theoretically indeterminate and varies across industries and products, depending in part on the speed of entry and extent of competition from substitute products"<sup>10</sup>.

Moreover, there are also trade-related aspects of intellectual property rights that need to be considered. First, the overall effect of intellectual property rights on trade flows is ambiguous. While it is certainly true that many nations deny patent protection to pharmaceuticals and as a result, some pharmaceutical companies face foreign competitors who misappropriate information to produce inexpensive imitations<sup>11</sup>, it is not entirely clear whether worldwide harmonisation of intellectual property rights would increase international trade flows. On the one hand, it is often pointed out that a firm may be deterred to export its patented good into a foreign market, if potential "pirates" can diminish the profitability of the firm's activity in that market because of a weak intellectual property rights regime. Accordingly, a strengthening of a country's patent regime would tend to increase imports as foreign firms would face increasing net demand for their products reflecting the displacement of pirates<sup>12</sup>. On the other hand, however, differing levels of intellectual property rights protection may affect a firm's decision on its preferred mode of serving a foreign market. A

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<sup>7</sup> Interviews.

<sup>8</sup> See Arrow (1962). See also Doane (1996), p. 469 and Fink and Primo Braga (1992), p. 2.

<sup>9</sup> See Danzon (1994), pp. 14f.

<sup>10</sup> *Ibid.*, p. 15.

<sup>11</sup> See Dam (1987) and *Basic Framework of GATT Provisions on Intellectual Property*, Statement of Views of the European, Japanese and US Business Communities (1988), quoted in Doane (1996), p. 470.

<sup>12</sup> See for example Fink and Primo Braga (1999), p. 2.

firm may choose to serve a foreign market by foreign direct investment or by licensing its intellectual asset to a foreign firm instead of exporting the product in an environment characterised by strong intellectual property rights. Thus, strengthened patent protection may have a negative effect on trade flows<sup>13</sup>. In view of these caveats, Maskus and Penuharti have argued that the overall effect of intellectual property protection on trade flows is theoretically ambiguous<sup>14</sup>.

Second, from a trade theory perspective it is far from clear that all countries should be required to maintain the same level of intellectual property protection. While intellectual property rights certainly provide incentives for innovation, they may also entail at least short-term consumer welfare losses and discourage imitation and adaptation by competitors, which themselves constitute valuable economic activities. Hence the level of intellectual property protection each country chooses will be rationally related to whether its comparative advantage resides more in innovation or imitation and adaptations of innovations made elsewhere, and the relative weight it gives to the interests of consumers, imitators and innovators<sup>15</sup>. In other words, it is not clear whether global welfare is enhanced by worldwide harmonisation of patent laws. In fact, a number of studies have tried to analyse whether the economic welfare gains to countries, which benefit from stricter protection outweigh the losses to those countries, which lose by it. The conclusions have been ambiguous: from a static welfare point of view, intellectual property rights can be viewed as a rent transfer mechanism, which deteriorates the international allocation of production. Most studies conclude that the destination country loses from tighter protection whereas the source country is usually better off as it can capture increased monopoly profits from the sale of its goods abroad<sup>16</sup>. However, the case is not entirely straightforward since benefits of a dynamic nature can be identified for both trading partners. A number of authors have argued that the introduction of intellectual property rights can be expected to stimulate innovation in the source country and thus will increase future trade flows. This will be beneficial for both trading economies assuming that the social returns on these innovations exceed private returns. In this view, worldwide harmonisation of intellectual property rights will lead to

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<sup>13</sup> See for example Ferrantino (1993).

<sup>14</sup> Maskus and Penuharti (1995).

<sup>15</sup> See Trebilcock and Howse (1999), pp. 307f.

<sup>16</sup> See for example Chin and Grossman (1988), Deardorff (1991), Helpman (1993) Maskus (1991) and Grossman and Helpman (1991).

continued technological progress and economic growth, and from a dynamic point of view, will be beneficial for both leaders and followers<sup>17</sup>.

In short, while intellectual property rights can be seen as an adjustment mechanism that promotes the functioning of dynamic competition between countries, they clearly also introduce static distortions in the sense that access to proprietary knowledge is sold above its marginal cost<sup>18</sup>. In view of this caveat, and the ones mentioned before, it appears difficult to classify MNEs' preference for strong intellectual property protection and worldwide harmonisation of patent laws as either market conforming or non-conforming. It is a grey area, which requires the weighing of a number of factors.

## Health Care Policies

Chapter 1 has pointed out that health care markets in all countries are subject to high levels of regulation. Indeed, a report by the *National Health Care Associates (NERA)* has noted that all European governments intervene substantially in their health care markets through, for example, direct control of drug prices, indirect price control by limiting the reimbursement level and mandatory price cuts or freezes<sup>19</sup>. In other words, health care policies not only determine the extend, to which the price mechanism is allowed to function in the health care sector, but also directly affect MNEs' profits and are thus of critical importance for the pharmaceutical industry.

Before, however, turning to the six MNEs' policy preferences, it is first necessary to define free market preferences within the context of health care policy. Problems arise because it is virtually universally acknowledged that *some* government regulation is both necessary and desirable in order to guarantee health care coverage that is available to and affordable by all citizens<sup>20</sup>. In fact, Danzon has argued that the competitive approach to health care recognises that governments should provide subsidies to ensure coverage is affordable for low income and high-risk individuals<sup>21</sup>. Additionally, regulations in the form of national health services or social insurance programmes are required, since it is generally acknowledged that individual consumers are not in a position to weigh a medical service

<sup>17</sup> See for example Diwan and Rodrik (1991) and Fish and Speyer (1995).

<sup>18</sup> See Fink and Primo Barga (1992), p. 2, Fink and Primo Braga (1999), p. 4 and Primo Braga (1996).

<sup>19</sup> NERA (1994), pp. 2ff.

<sup>20</sup> See Danzon (1994), p. 3.

<sup>21</sup> Ibid.

against its price. Sommer has argued that this would require a level of professional expertise that could not be expected of an average consumer<sup>22</sup>.

However, it is still possible to distinguish between market-conforming and non-conforming health care policies. The difference has mainly to do with the effects of regulations on problems of moral hazard that in the case of health care have the potential to significantly distort supply and demand conditions. Danzon has observed that insurance programmes tend to make consumers indifferent to costs, because “someone else is paying” and thereby encourage over-consumption<sup>23</sup>. Moreover, because insurance tends to make demand inelastic, it raises the profit maximising price that suppliers of insured services and products (e.g. pharmaceutical MNEs) would seek to charge. In other words, health care regulation has the potential to encourage overuse and higher prices, or, to put it differently, the moral hazard effect implies that health care regulations can entail a deadweight loss or excess burden<sup>24</sup>. Economic theory thus concluded that market-conforming insurance programmes should include some constraints. If well designed, such constraints are in the long run in the interests of consumers, who ultimately pay for overuse through higher insurance premiums or higher taxes. These constraints may include consumer incentives such as co-payments, and provider incentives such as capitation and other risk-sharing forms of reimbursement<sup>25</sup>. Moreover, while government subsidies may be essential to guarantee that health care coverage is affordable for everyone, these subsidies should not extend beyond basic health care services, and consumers should be left free to purchase more comprehensive care with their own income and without additional subsidies<sup>26</sup>.

In practical terms this means that in competitive health care markets, patients can choose between various insurance plans and insurers compete by trying to design plans that provide a mixture of choice, quality and out-of-pocket and premium cost that most appeals to consumers. Drug prices should be free and governments should not intervene in prescribing practices of physicians or in the patients’ choice of a physician<sup>27</sup>. A number of authors have

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<sup>22</sup> Sommer (1997).

<sup>23</sup> Danzon (1994), p. 3. The positive relationship between insurance and utilisation has been demonstrated scientifically in the RAND health insurance experiment. See Manning (1987).

<sup>24</sup> See Danzon (1994), pp. 15f.

<sup>25</sup> See Zeckhauser (1971) and Ellis and McGuire (1993). See also Danzon (1994), p. 17.

<sup>26</sup> Danzon has argued that as soon as consumers face the full costs, if they choose to spend more on health insurance, there is no reason for the government to control these choices. Governments have no superior insight into the appropriate level of health care spending, and any limit other than one derived from consumer choices is as arbitrary when applied to health care as it would be for automobiles or videocassette recorders. Such arbitrary limits reduce consumer well-being since, by definition, they force consumers from their preferred consumption patterns. See Danzon (1994), pp.4f.

<sup>27</sup> See Danzon (1994), p. 5.

argued that if consumers face the full cost of their choices, there is no reason why competition in health insurance markets should not hold health insurance premiums and prices for medical services at appropriate levels. In fact, there is ample evidence that competing health insurance plans are innovative in designing strategies to control insurance-induced excess spending<sup>28</sup>.

The health care policy preferences of the six MNEs' preferences have been unambiguous and straightforward. Through their trade associations, they have been advocating policies aimed at increasing competition in the sector through measures to ensure the physician's freedom to prescribe, the patient's free choice of the physician and the promotion of innovation and technological progress through a market-based order<sup>29</sup>. In the words of one Swiss executive,

"industry supports policies that aim to embed all market participants in a market order with incentives for cost-consciousness"<sup>30</sup>.

In similar vein, executives from the German MNEs argued that promoting competition in the health care market by giving doctors and patients more choice in the selection of drugs had always been a priority for them<sup>31</sup>. Far from seeing government's inevitable involvement as an opportunity for rent-seeking, all six MNEs advocated free prices, a maximum of competition and a system in which consumers faced the full costs of their drug purchases. All of them, for example, advocated co-payments as a means to foster cost-consciousness among consumers<sup>32</sup>.

For an explanation of these preferences, MNEs' business focus and sectoral characteristics were decisive. In fact, all interviewed executives linked their preference for competition-promoting measures to their business focus - the development of new and innovative drugs – since, in their view, free health care markets were the best mechanism to reward innovation<sup>33</sup>. One German executive commented that

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<sup>28</sup> Ibid. See also Sommer (1997).

<sup>29</sup> See for example *Interpharma* (1990) and *Bundesverband der Pharmazeutischen Industrie* (BPI) Annual Report (1996), pp. 16ff.

<sup>30</sup> Speech by SGCI President Andres Leuenberger at the Annual General Meeting of the SGCI in 1992.

<sup>31</sup> Interviews.

<sup>32</sup> See for example *Bundesverband der Pharmazeutischen Industrie* (BPI) Annual Report (1996), p. 17, Sommer (1997), p. 14, *Interpharma* (1990), and Humer (1997), p. 65.

<sup>33</sup> For the argument that innovation is best rewarded by giving consumers a maximum of choice and by an incentive structure that fosters cost-consciousness among all participants in the health care market see Danzon (1995), Sommer (1997), Humer (1997), p. 62 and Leuenberger (1992).

“since we are in the business of developing innovative drugs - drugs that are superior to existing ones - we believe that giving consumers more choice is ultimately the best strategy to promote our products. After all, given free choice, consumers are unlikely to select second-best products”<sup>34</sup>.

In similar vein, a Swiss executive added that

“our strategy to focus on the development of new and innovative drugs implies that we strongly support policies that give consumers a maximum of choice. In our view, this is best done through a market-oriented health care system.”

*Interpharma*’s general-secretary pointed out that the pharmaceutical industry asked for less rather than more state intervention in health care markets, since all research indicated that giving consumers more choice in the selection of drugs was the best way to reward innovation<sup>35</sup>. In other words, a business focus on innovative drugs led all six MNEs to support competition-promoting health care policies. However, sectoral characteristics were also important in this context in order to explain the actual policies through which this preference was expressed (e.g. co-payments). Clearly in other sectors, the preference for such a policy would not necessarily be considered as market conforming since it leaves a substantial role for the state to finance consumer needs. In the health care sector, however, it was shown that due to sectoral characteristics such a preference could indeed be considered market conforming.

### **Biotechnology Regulation**

The previous chapter has pointed out that biotechnology has become highly important for the pharmaceutical industry and that all six MNEs strongly embraced this new technology. As a result, biotechnology regulations featured prominently on the six MNEs’ political agendas. For analytical clarity, it is useful to distinguish between two sets of regulations: one dealing with the approval for drugs derived from the application of biotechnology and one dealing

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<sup>34</sup> Interview.

<sup>35</sup> Interview.

with the approval of production facilities and research projects. Both sets of regulations can be price mechanism promoting, distorting or suspending. *EuropaBio* has pointed out that market conforming biotechnology regulations provide a level playing field and establish a regulatory framework that is characterised by a maximum of predictability, legal certainty and transparency. Moreover, regulations should be based on scientific principles, be flexible enough to facilitate technological change and ensure adequate consumer protection<sup>36</sup>.

With regard to both sets of regulations, the preferences of the six German and Swiss MNEs' were unambiguous. Rather than seeking government support or promotion programmes that would tilt the playing field in their favour, all six strongly supported framework-oriented regulations that were based on scientific principles and established predictability, legal certainty and transparency<sup>37</sup>. In the words of one German executive,

“our foremost aim has been the establishment of a regulatory regime that is predictable and free from political meddling”.

In similar vein, *Interpharma* has repeatedly argued that it supported a regulatory regime that was transparent, flexible and predictable<sup>38</sup>. Roche's CEO Humer remarked that

“industry does not demand no regulations - we accept control mechanisms, but they have to be predictable and transparent”<sup>39</sup>.

How can one explain this preference? Clearly, the six MNEs' business strategy of embracing biotechnology gave them a strong interest in the issue, and this interest was certainly further buttressed by the increasing number of economic opportunities from the application of this technology. However, it seems overly general to argue, as some authors have done, that this interest in the issue by itself explained MNEs' preference for deregulation and a minimum of state involvement<sup>40</sup>. Rather interviewees emphasised the importance of being able to react swiftly to new scientific developments and argued that state involvement would only result in a loss of flexibility to adjust to the latest discoveries. As

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<sup>36</sup> See *EuropaBio* (1997), p. 81.

<sup>37</sup> Interviews. See also interview with Andres Leuenberger in *Basler Zeitung* Jan. 5 1991. For a similar view see Daniel Wagniere “Die Grenzen des Politisch Machbaren”, *Basler Zeitung*, June 7 1997.

<sup>38</sup> See for example *Interpharma* (1990).

<sup>39</sup> Humer (1997), p. 84.

<sup>40</sup> See for example Gill (1997).

one German executive has put it, “we want to stay flexible and we do not believe that the state has any superior insight into future scientific developments”<sup>41</sup>. A Swiss executive added that

“flexibility to react to new scientific discoveries in the way we see fit is of paramount importance for us. State involvement - be it through tight regulatory measures or promotion programmes - would only curtail our freedom of action”<sup>42</sup>.

In other words, the preferences of the six MNEs in this issue area cannot directly be linked to their internationalisation processes, their business focus or sectoral characteristics, but rather resulted from a general desire for a maximum of flexibility when it came to their R&D activities.

### Parallel Imports

According to executives from the three German MNEs, the problem of parallel imports has emerged during the last decade as one of the most important issues facing the German pharmaceutical industry. Essentially parallel trade in pharmaceuticals is a consequence of the single European market, which on the one hand encourages the free flow of drugs across EU countries but, on the other hand, leaves member states free to regulate their health care systems as they wish. This regulatory freedom resulted in significant price differentials for patented medicines. Research conducted by *NERA* has pointed out that at the end of 1994, prices in the Netherlands were over 75 per cent higher than those in Spain and there was a range of prices in between. The consequence has been that private dealers discovered a lucrative trade reselling “cheap” drugs bought in low price regions to consumers in countries where prices are higher, such as Germany<sup>43</sup>.

The German MNEs were strongly opposed to parallel trade and advocated measures to segment European health care markets along national lines. Seen through the lens of the conventional wisdom that explains MNE’s trade policy preferences as a result of their exposure to international markets, this preference is surprising. Chapter 2 has pointed out that

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<sup>41</sup> Interview.

<sup>42</sup> Interview.

<sup>43</sup> *NERA* (1996), p. 4f.

all three German MNEs were highly internationalised and should not be expected to advocate any border restrictions to international trade. Sectoral characteristics can provide an explanation for this anomaly. Executives from the three MNEs argued that they were opposed to parallel imports since price differentials only reflected the fact that some governments were more willing than others to contribute to the financing of R&D<sup>44</sup>. They argued that parallel trade would inevitably induce downward spillover pressure on prices and thereby undermine the adequacy of revenues to pay for R&D<sup>45</sup>. As one executive put it,

“in the long run it is not sustainable to have a European single market based on the principle of free movement of goods, while at the same time allowing individual countries to establish their own regulatory systems for health care, which is leading to different drug prices. Inevitably the result is going to be that prices will converge on the lowest price in the trading bloc and this will undermine the ability of pharmaceutical companies to set prices to cover the costs of R&D in the most efficient manner... If incentives for innovative R&D are to be preserved, there is a strong case for exempting from parallel trade pharmaceuticals that are subject to price regulation”<sup>46</sup>.

Judging whether this preference is market conforming or non-conforming is not as straightforward as it may seem. In fact, from the three MNEs’ point of view, the preference for market segmentation was not protectionist at all since, as all interviewed executives argued, free trade under these circumstances was neither fair nor welfare enhancing. They argued that it was not fair because lower prices did not reflect superior efficiency and lower input costs, but rather countries achieved low drug prices and became parallel exporters usually through denial of intellectual property protection or through stringent regulation<sup>47</sup>. Moreover, citing the theory of Ramsey pricing, the industry argued that the preference for market segmentation was actually welfare enhancing. Addressing the question of how a firm operating in several markets should most efficiently recoup sunk costs, which are common across these markets, the theory of Ramsey pricing suggests that relatively higher prices

<sup>44</sup> Danzon and Kim (1995) have noted that in order to provide incentives for innovative R&D, governments in countries with successful domestic research-based pharmaceutical firms - such as for example Germany, Switzerland, the UK and Sweden - have traditionally been more willing to grant higher prices.

<sup>45</sup> Interviews.

<sup>46</sup> For a similar view see Danzon (1994), p. 36 and NERA (1994), p. 28.

<sup>47</sup> For a similar view see Danzon (1994), p.24. For the argument that high levels of price regulation actually reduce efficiency and productivity see Danzon and Percy (1996); for the negative effects on innovation see Thomas (1996).

should be charged where the market can best bear them. This leads to welfare gains compared to uniform pricing, because more revenue is earned in those markets where the quantity demanded is relatively insensitive to the prices charged and thereby allows lower prices in markets where the quantity demanded is more price sensitive. The result is a higher overall level of output and an increase in social welfare<sup>48</sup>. Put differently, the three MNEs were arguing that their sales had to contribute to the costs of the overall R&D programme, which could be viewed as a sunk cost, and in a situation where sunk costs needed to be recouped from total sales to a number of markets, price differentiation could raise social welfare. As one executive has put it,

“allowing parallel imports lacks any efficiency rationale. On the contrary, by inducing downward spillover pressures on prices, such regulation tends to undermine optimal price differentials and undermine the adequacy of revenues to pay for R&D“.

Another interviewee added that

“in the pharmaceutical sector, welfare maximising prices require charging different prices to different users, based on their differing price sensitivity of demand and willingness to pay for innovative medicines”.

A cynic might, however, respond to these arguments that the motivation to prevent parallel imports simply comes down to a desire to protect monopoly privileges by keeping prices high and undersupplying the market. In short, similar to intellectual property rights, MNEs’ preferences with regard to parallel imports cannot easily be labelled market conforming or non-conforming, but rather occupy another grey area. While segmenting health care markets along national lines is certainly hardly compatible with the requirements for free price competition, it may nevertheless lead to superior results with regard to welfare. It may, however, also lead to unjustifiably high drug prices in some countries and monopoly rents for pharmaceutical MNEs.

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<sup>48</sup> See NERA (1996). The conclusion that uniform prices are generally not welfare enhancing for innovative pharmaceuticals is also reached by Danzon (1994). See also Ramsey (1927).

## The Economic Policy Preferences of the Six Pharmaceutical MNEs: An Analysis

Judging whether the six MNEs' policy preferences promote, distort or suspend the price mechanism is not entirely clear-cut. Only with regard to biotechnology regulation has the case been relatively clear cut: all six MNEs strongly supported a regulatory framework that established legal certainty, ensured transparency and was based on scientific principles. In other words, a regulatory framework in which the price mechanism could fulfil its undistorted signalling function<sup>49</sup>.

Certainly the six MNEs' policy preferences with regard to health care policies were also market conforming. However, the case here was slightly complicated by sectoral characteristics that rendered the meaning of free competition somewhat different to that in other sectors. It was shown that the competitive approach to health care recognised a legitimate role for government intervention and regulations, which in other sectors could be considered as price mechanism distorting. It was argued that market conforming policies in the health care sector distinguished themselves by the extent to which they included constraints to reduce problems of moral hazard resulting from regulations. All six MNEs strongly supported such constraints and advocated measures that gave consumers a maximum of choice and fostered cost-consciousness.

The picture became a bit muddier with regard to the six MNEs strong support for the protection of intellectual property and the worldwide harmonisation of patent laws. It was shown that the literature was not unanimous in its findings regarding the effects of intellectual property protection on the functioning of the market mechanism and overall economic welfare. With regard to worldwide harmonisation of patent laws, it appeared that a case could be made that the preferences of the six MNEs came more than close to rent-seeking.

Similarly, the three German MNEs preference for segmenting health care markets along national lines in order to prevent parallel imports from other EU member states was somewhat ambiguous. Clearly, in other sectors such a preference would be downright protectionist. In the pharmaceutical sector, however, it was shown that various factors complicated such a verdict.

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<sup>49</sup> If one, however, includes intellectual property rights for genetically engineered products, and processes, the case becomes less straightforward and is subject to the caveats discussed before.

Turning to an explanation of the six MNEs' policy preferences, three of the four analysed policy issues fit in well with the argument of Chapter 1 that an analysis that sought to examine MNEs' economic policy preferences needed to go beyond the extent and nature of MNEs' internationalisation process, and also incorporate their business focus and sectoral characteristics as additional explanatory factors.

It was shown that MNEs' preferences with regard to health care policies could be explained by the six MNEs' business focus on innovative drugs, which gave them a strong interest in free prices and in ensuring that consumers got a maximum of choice. Moreover, sectoral characteristics were important for an explanation of the actual policies through which this preference was articulated (e.g. co-payments).

Regarding intellectual property rights, sectoral characteristics – long and expensive R&D periods and the fact that drugs can be easily replicated – gave firms a strong interest in the protection of intellectual property. However, internationalisation and business strategies were also important. As a result of increasing international sales, the six MNEs became strongly interested in the global harmonisation of patent laws. Moreover, their preference for strong protection of intellectual property was further buttressed by their business focus on research-intensive drugs.

With regard to parallel imports, it was again sectoral characteristics that gave the three German MNEs a strong interest in the segmentation of EU health care markets along national lines. All three MNEs argued that different, country-specific health care regulations rendered free trade in prescription drugs neither efficient nor welfare-enhancing. It was pointed out that this preference was somewhat surprising - at least when looked at through the lens of the conventional theories that explained MNEs' trade policy preferences as a result of their exposure to international markets - since all three MNEs were highly internationalised and hence should not be expected to support restrictions on international trade.

The only preference that could not really plausibly be explained by MNEs' internationalisation process, their business strategies or sectoral characteristics was the six MNEs' preference with regard to biotechnology regulations. Although some authors have linked MNEs' preference for a market conforming regulatory framework to their business strategy of embracing biotechnology, this appeared not entirely convincing - all interviewees linked this preference to a general desire for a maximum of flexibility with regard to their R&D activities.

## The Six German and Swiss Banks

Trade in the German and Swiss financial services sector is free in the sense that markets in both countries are only regulated to ensure the safety of individual banks and the financial system as a whole<sup>50</sup>. These regulations are, however, qualitatively different to those of goods markets due to the existence of problems of moral hazard, information asymmetries and other characteristics related to financial services (see below). Prior to the GATS Agreement in Financial Services, access to Germany's and Switzerland's banking sector was granted on the basis of bilateral reciprocity – the principle that a country discriminated in its treatment of foreign firms by affording each of them exactly the same treatment that the country's own firms received in its home country. In both countries there was no evidence that this principle had been abused for protectionist purposes<sup>51</sup>. That does, however, not mean that in both countries an undistorted price mechanism matched supply and demand in the most efficient manner. In fact, during the period from 1985 to roughly 1995, both the German and the Swiss financial service sector underwent important reforms. In both countries these reforms centred around market access conditions and regulatory issues. Moreover, in Germany, state-sanctioned privileges for public sector banks also became an increasingly contentious issue during the 1990s.

### Market Access Issues

Market access issues varied slightly for the three German and Swiss banks. One policy issue, the GATS Agreement for Financial Services, was of relevance for both the German and Swiss banks. In addition, the German banks were strongly affected by financial liberalisation measures within the context of the Single European Act (SEA), and the Swiss banks by the controversy surrounding the banking conventions through which the *Swiss Bankers' Association* administered competition in the banking sector. Before turning to these issues, however, a brief word about the nature of trade barriers in financial services is in order.

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<sup>50</sup> See for example Chapuis (1990), Niethammer (1990), *Federal Association of German Banks (FAGB)* Annual Report (1998), p. 37, *Swiss Bankers Association (SBA)* Annual Report (1995/96), p.102 and *Eidegnössisches Finanzdepartment* (1989)

<sup>51</sup> See IMF (1989a) and Huang (1992).

At the level of general principle, the effects of free trade in financial services are similar to those in manufacturing. Numerous studies have found that free markets for financial services promote efficient investment and are better at allocating financial resources than bureaucracies<sup>52</sup>. A number of authors have argued that liberalisation of financial services has strong positive effects on income and growth<sup>53</sup> and Kono has argued that the driving forces behind these effects have been the same as in other sectors: specialisation on the basis of comparative advantage, realisation of economies of scale and scope and dissemination of know-how and new technologies<sup>54</sup>. However, despite these similarities, market access issues are somewhat more elusive in the financial service sector. Essentially this is the result of the fact that trade in financial services often differs from trade in goods in terms of the linkages that exist between producer and consumer. Unlike international trade in goods, trade in financial services requires in many cases the simultaneous interaction of buyer and seller, and hence a commercial presence in the host country is often necessary to provide services in another country. Certainly this also occurs in trade in goods through FDI, but as Walter has argued, such a mechanism is much more important in the case of financial services<sup>55</sup>. As a corollary, controls and restrictions over the establishment and operation of foreign affiliates determines, in large measure, the degree to which a national market is open to foreign competition<sup>56</sup>. In other words, trade distortions in financial services do not take the form of border charges or qualitative trade controls, but rather restrictions in the ability of banks to operate on the ground in the target market itself<sup>57</sup>.

However, as has been pointed out in the previous chapter, financial services can also be traded through other modes of supply, such as for example through the movement of data and money across borders. In these cases, exchange and capital movement controls, as well as regulations or restrictions of trans-boundary data flows may constitute barriers to trade in financial services. However, one could go further and also include other regulations. For example, in cases where trade in financial services occurs through the movement of people, immigration restrictions that prevent temporary entry for purposes of providing a service, as

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<sup>52</sup> For the costs of financial repression see McKinnon (1973) and Shaw (1973). For the strong positive correlation between investment and financial liberalisation see King and Levine (1993).

<sup>53</sup> Levine (1996, 1997) and King and Levine (1993) have shown that countries with open financial sectors have typically grown faster than those with closed ones. Hoj, Kato and Pilat (1995) and Levine (1996) have pointed out that financial reform in OECD countries banking sectors has resulted in improvements in most indicators of operational efficiency.

<sup>54</sup> See Kono (1997), p. 17. See also Zutshi (1995).

<sup>55</sup> See Walter (1985), p. 13. Recent development in information technology and e-commerce may, however, soon challenge this assumption.

<sup>56</sup> Ibid., p. 20. See also Walter (1988), p. 111.

well as restrictive licensing and certification requirements, may constitute barriers to trade in financial services. Finally, trade in services can also occur through access to a network, e.g. telecommunications or payment systems. Hence the terms of access or interconnection with such networks may constitute barriers to trade<sup>58</sup>. However, in order to keep the number of policy issues to a manageable number, this study will be only concerned with policy areas directly related to financial services<sup>59</sup>.

Turning now to policy issues, the major market access issue for both the German and Swiss banks during the last decade has been the GATS Agreement for Financial Services, which was negotiated during the Uruguay Round but only concluded in 1997 when the WTO had already come into effect. The aim of the agreement was to bring trade in financial services into the WTO framework and to extend the MFN principle (the principle that concessions awarded to one country must be automatically extended to all signatories of the agreement) to trade in financial services<sup>60</sup>. Although the agreement contained a large number of exceptions relating to natural treatment and market access issues, it was nevertheless expected to improve the international allocation of capital and risks<sup>61</sup>.

Despite their selective internationalisation processes, all six banks strongly supported this agreement and praised all efforts towards a liberal and open international order for financial services<sup>62</sup>. If anything, the six banks complained that the agreement was not far-reaching enough, in the sense that not all developing countries (and also some developed countries) agreed to the proposed liberalisation measures (see Chapter 7)<sup>63</sup>. Interviewees particularly stressed the advantages of having financial services within the jurisdiction of the dispute settlement mechanism and all of them linked this preference to the increasing internationalisation of their business activities. In the words of one executive,

“with the increasing internationalisation of our business operations, we became

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<sup>57</sup> See Walter (1988), p. 112, Huang (1992), p. 258 and Smith and Walter (1990), pp. 752ff.

<sup>58</sup> See Walter (1988), p. 193.

<sup>59</sup> In fact, in a recent survey of financial liberalisation, Williamson and Ahar have argued that there are six dimensions of financial sector liberalisation: abolishing of credit controls, freeing of international capital flows, deregulation of interest rates, allowing free entry into the banking sector, making banks autonomous (that is, freeing them from ad hoc interference in day to day management) and putting banks in private ownership. See Williamson and Ahar (1998). For a similar view see Gelb and Sagari (1990), p. 10ff.

<sup>60</sup> Natural Treatment and Market Access principles were extended to financial services through Annex XXIII and Annex XVI.

<sup>61</sup> See Kono (1997) and Sorsa (1997). See also Chapter 7.

<sup>62</sup> Interviews. See also SBA Annual Report (1989/90), p. 106, Annual Report (1995/96), p. 102 and FAGB Annual Report (1996), p. 127.

<sup>63</sup> Interviews. See also SBA Annual Report (1995/96), p. 102 and FAGB Annual Report (1996), p. 127.

increasingly aware of the need to have some form of internationalised intermediation procedure”<sup>64</sup>.

In other words, with regard to the GATS Agreement in Financial Services there has been a clear and direct link between the internationalisation processes of the six banks and their preferences. There were no signs that the selective nature of banks internationalisation processes weakened their support for open international markets in financial services.

The second market access issue during the late 1980s and 1990s centred around European directives for the establishment of a single market in financial services within the context of the Single European Act. These directives primarily concerned the German banks, but Chapter 6 will show that the Swiss banks were also affected. The European directives went a lot further than the GATS Agreement with their liberalisation efforts, since they not only addressed market access issues, but also aimed to establish common regulatory and supervisory standards among member states (see Chapter 7).

The three German banks strongly supported the initiative for the establishment of a single European market in financial services<sup>65</sup>. However, this support was not so much based on improved market access opportunities – Chapter 2 has noted that none of the six banks planned to establish a pan-European branch network – but rather on the desire to overcome the fragmentation of Europe’s capital markets (see Chapter 7). All interviewees argued that European wholesale markets were considerably fragmented due to different regulatory frameworks – something, which in their view, depressed market liquidity. Moreover, these regulatory differences between European countries made it difficult and expensive for banks to do business across national jurisdictions<sup>66</sup>. In the words of one executive,

“the European directives for the establishment of a single market in financial services corresponded to our general preference for a maximum of regulatory harmonisation between countries”<sup>67</sup>.

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<sup>64</sup> Interview.

<sup>65</sup> See FAGB Annual Reports.

<sup>66</sup> Interviews.

<sup>67</sup> Interview.

As will be elaborated in the next section, the preference for an international harmonisation of regulatory and supervisory standards can be explained by a combination of banks' internationalisation processes and their business strategies.

A last market access policy issue concerns the Swiss banks. Although Switzerland's banking sector has long been free from public policies or regulations that discriminated against foreign banks, the issue of market access was until the early 1990s far from clear cut. While both the three German and the three Swiss banks strongly supported a rule-based, open international trading system for financial services, their preferences diverged sharply – at least prior to 1990 – when it came to competition in the domestic banking sector. Although Credit Suisse, SBC and UBS competed fiercely against each other in international markets, they preferred "administered" competition in their home market. Through the *Swiss Bankers' Association (SBA)*, they agreed on a number of "conventions", which regulated a large number of business activities ranging from mortgage rates and deposit fees, to advertisements and the number of branches each bank was allowed to operate in Switzerland<sup>68</sup>. In other words, the three banks supported a number of highly illiberal practices that suspended the market mechanism. From the three banks' point of view, these conventions had, however, nothing to do with rent-seeking. The *SBA*'s chief economist argued that these measures were necessary for the smooth functioning of the Swiss financial centre and, in fact, "raised efficiency, enhanced transparency and allowed a soft adjustment process"<sup>69</sup>. What mattered, so the three banks, was not competition *per se*, but rather market outcomes and the contestability of the market<sup>70</sup>.

Analysing a number of performance indicators - such as returns on assets and equity, interest margins, foreign share in total banking assets or liabilities, relative shares of banking activities in the economy, concentration ratios, profit or intermediation margins - Bossard, Wirth and Blattner have argued that Switzerland's banking sector was efficient and open<sup>71</sup>. However, Sorsa, among others, has noted that interpreting these indicators was difficult. Performance indicators can vary across countries for reasons such as perception of risk and size of market, with little relation to competition or openness as such. Moreover, prices can

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<sup>68</sup> It might be objected that these conventions amount to a private arrangement between Switzerland's banks and hence do not fall into the category of public policies. However, Chapter 4 will argue that one of the distinguishing characteristics of Switzerland's policy-making system is its so-called private interest or militia government: a system of policy-making which relies on organised interests for the drafting and implementation of public policies. Hence it is entirely justifiable to include the banking conventions in an analysis of banks' preferences with regard to public policies.

<sup>69</sup> See Blattner (1991), p. 98.

<sup>70</sup> Ibid. For a similar view see Graham and Lawrence (1996).

<sup>71</sup> Bossard, Wirth and Blattner (1992).

vary according to quality or differentiation of products. Finally, profits in some markets can be high because risk premiums are high, or concentration ratios of banks can depend on the economic size of the market or the firm<sup>72</sup>. In other words, the line that divided the three Swiss banks' preference for administered competition from rent-seeking appeared to have been very thin. In fact, in 1990 the Swiss government abolished all conventions and introduced price competition for all financial services. Despite initial reservations, the three banks came round to accept the need for a market-based order and henceforth supported competition-promoting measures (see Chapter 6).

Explaining the three Swiss banks' preference for administered competition through the explanatory framework of this study is difficult. First, it was noted that the Swiss banks were during the 1980s more internationalised than the three German banks. Hence, at least according to the conventional wisdom, they should be more supportive of free markets than the German banks. Clearly this has not been the case. Second, there have not been any major differences in the six banks' business focus and obviously all six were subject to the same sectoral characteristics. Yet the Swiss banks' preferences in this issue area have been very different from the German banks. While the latter were supporting liberal framework conditions, the Swiss banks preferred policies that suspended the market mechanism.

This finding represents a significant anomaly and suggests that apart from the extent and nature of MNEs' internationalisation process, their business focus and sectoral characteristics, other factors may also shape MNEs' preferences. One possible explanation in this case is Germany's and Switzerland's differing attitude towards competition policy. The following chapter will point out that many of Germany's economic policies have over the last decades been characterised by stringent competition policies, whereas Switzerland has been more cartel-friendly. It is, however, beyond the scope of this study to explore this issue further.

## **Regulatory Issues**

Both the German and the Swiss financial service sector underwent important regulatory reforms during the last decade. In both countries these reforms centred around adjusting the domestic regulatory framework to securitisation and international norms and standards.

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<sup>72</sup> See Sorsa (1997), p. 23.

Before, however, turning to these issues and the six banks' preferences, a brief word about banking regulation is in order.

As has been pointed out in Chapter 1, there is widespread consensus that the financial service sector should be subject to special regulations<sup>73</sup>. Virtually everybody agrees that investors need to be protected due to information asymmetries<sup>74</sup>, that banks are inherently unstable because of the promise they make to redeem deposits at par on demand<sup>75</sup>, and that banking crises always carry with them negative externalities<sup>76</sup>. Walter has noted that

"it is conventional wisdom that major banking crises can lead to severe damage to employment, income, economic growth and related goals of society"<sup>77</sup>.

In order to protect themselves against such adverse consequences and to ensure the safety and stability of national financial systems, countries have built elaborate regulatory systems and safety nets. Additionally – and to cope with the inevitable problem of moral hazard<sup>78</sup> – governments apply various techniques of financial surveillance and control. These range from reserve requirements, mandatory asset ratios, and maximum lending limits to risk-related deposit insurance premiums, disclosure provisions and securities laws<sup>79</sup>.

With the increasing integration of global capital markets, these regulatory and supervisory measures have taken on an additional importance. Kono has argued that adequate prudential regulation and supervision become particularly important in open financial markets, as liberalisation with its intensified competitive pressures reduced the ability of institutions to "survive" poor performance<sup>80</sup>. Moreover, it has often been pointed out that trade in services

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<sup>73</sup> See for example Spong (1990).

<sup>74</sup> As with all services, the quality of financial services cannot be assessed *a priori*, but only while the service is consumed. As a result, producers know inevitably more about their product than consumers; hence the need for regulation to assure consumers about the quality of the service they are purchasing. See Schenker (1996), p. 10.

<sup>75</sup> A recent World Bank study identified banking crises in as many as 69 countries since the late 1970s. See Caprio and Klingebiel (1996). A similar study by the IMF estimated that three quarters of IMF member countries experienced "significant bank sector problems" between 1980 and 1995. See Lindgren et.al. (1996).

<sup>76</sup> See Walter (1985), p. 1 and Walter (1988), pp. 2ff.

<sup>77</sup> See Walter (1988), p. 37.

<sup>78</sup> Through underwriting banks' debts - either explicitly (through deposit insurance) or implicitly (by letting it be understood that banks will not be allowed to fail) – the existence of safety nets create potential "moral hazard" problems where management of financial institutions, knowing that they are likely to be bailed out, will behave in a less risk-averse manner and thus impose substantial contingent liabilities on those who hold up the safety net – the taxpayers and the general public. See Walter (1988), p. 37 and BIS (1986).

<sup>79</sup> See BIS (1986).

<sup>80</sup> See Kono (1997), pp. 23, 27f. Commentators have often been quick to link banking sector problems to deregulation and liberalisation measures. However, a number of authors have noted that the key causes for

allows countries to shift beyond their own borders some of the negative welfare effects of their regulatory approaches. The existence of such spillovers can lead to contagion effects where instability or regulatory failure in one market undermines market confidence elsewhere<sup>81</sup>. In short, due to a number of sectoral characteristics, the financial service sector needs to be considerably regulated.

However, this does not mean that price competition must necessarily be distorted or suspended. The OECD has noted that

“regulation does not necessarily restrict or distort competition, quite to the opposite, it can also improve allocative efficiency by levelling the playing field for all participants as well as through rules, which enhance market transparency, strengthen investor confidence, reduce transaction costs and allow the financial system the flexibility to adjust to new circumstances”<sup>82</sup>.

Transparency is often singled out as a particularly important requirement for market conforming banking regulations. Schenker has pointed out that investor insecurity regarding the reliability and completeness of information will lead them to demand a risk premium, which will artificially raise the cost of capital. Moreover, transparency is of crucial importance for the marking conforming protection of investors. Rather than prohibiting certain financial instruments – something that is equal to saying that certain degrees of risk are not suitable for investors – market conforming investor protection provides a maximum of transparency and information in order to allow investors to make well-informed choices<sup>83</sup>.

Turning now to policy issues, the main policy initiatives in Germany and Switzerland centred around measures to adjust capital market regulations to securitisation, disintermediation and the growing integration of international capital markets. To this end,

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financial sector problems usually lie in unsound macroeconomic policies, inappropriate government intervention and inadequate regulation and supervision. See Harris and Piggot (1997), Jacquet (1997) and BIS (1997a). It should also be noted in this context that the liberalisation of financial services requires a stable macroeconomic environment since the adverse effects of inflation, large budget deficits or unsustainable exchange rates can be compounded by international financial flows. See World Bank (1997), BIS (1997), UNCTAD (1996). In fact, it has became a widely held view that financial liberalisation should not be introduced prematurely in the reform process of countries. See Johnston (1994), World Bank (1997), BIS (1997), Helleiner (1997).

<sup>81</sup> See for example IMF (1989), pp. 50-60 and Trebilcock and Howse (1999), p. 274.

<sup>82</sup> OECD (1991), p. 21ff. See also “Cooke’s Medicine: Kill or Cure?”, *Euromoney*, July 1988, pp. 34-54 and Schenker (1996), p. 22.

<sup>83</sup> See Schenker (1997), p. 10ff. Often cited in this context is the Royal Canadian Banking Commission’s comment of 1935 that “we should not take away from the citizen his inalienable right to make a fool of himself” (quoted in Schenker 1996, p. 12).

governments in both countries ratified a number of reform acts (see Chapter 6). The six banks' policy preferences with regard to these reforms have been unambiguous: all of them supported a regulatory framework, which was compatible with international norms and standards, provided for maximum of transparency and was conducive to the development of efficient capital markets<sup>84</sup>. All six banks strongly advocated measures to broaden and deepen capital markets in their countries. As one Swiss executive put it,

"the goal has to be to open the Swiss capital market to foreign supply and demand, as well as to new financial products; of particular importance are measures to create markets for venture capital, to enhance information and transparency and to establish internationally recognised supervisory standards"<sup>85</sup>.

A German executive argued that

"what is needed are measures to make it easier for companies to obtain stock market listings, a quicker approval of new financial instruments and a broadening of the corporate bond market segment to include junk bonds or high yield bonds, which will allow companies with low credit ratings to raise capital in the markets"<sup>86</sup>.

Moreover, the six banks strongly advocated reforms to adjust the German and Swiss regulatory frameworks to internationally recognised norms and standards. Both the *Federal Association of German Bank (FAGB)* and the *Swiss Bankers' Association (SBA)* have been repeatedly stating their preference for the harmonisation of banking regulations on an international scale<sup>87</sup>. Finally, all six banks were strongly in favour of measures to enhance to the organisational efficiency of the German and Swiss stock exchanges.

For an explanation of these preferences both banks' internationalisation processes and their business focus were of importance. All interviewed executives linked their preference for a deepening and broadening of capital markets - and for adjusting domestic regulation to internationally recognised norms and standards - to the increasing internationalisation of their business activities, and to a desire to operate in a domestic regulatory framework that is

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<sup>84</sup> Interviews. See also *FAGB Annual Report (1988)*, pp. 36-37 and *SBA Annual Report (1994/95)*, p. 58.

<sup>85</sup> Interview.

<sup>86</sup> Interview. See also "Kapitalmarktkultur entwickeln", *Börsenzeitung* December 4 1997.

<sup>87</sup> See for example *FAGB Annual Report (1998)*, p. 18 and *SBA Annual Report (1995/96)*, p. 39.

similar to those in international financial centres.<sup>88</sup> Moreover, since the important bits of the investment banking and asset management business are clustered in a few international financial centres from which they are exported to other countries, banks became strongly interested in being able to do business across national jurisdictions. However, stocks and future exchanges are in all countries regulated by national authorities and operate in national jurisdictions under national law – something, which makes it often difficult and expensive for banks to do business across national boundaries. Hence the strong preference for regulatory harmonisation on an international scale.

The finding that all interviewees linked their banks' preference for a broadening and deepening of domestic capital markets and for adjusting domestic regulations to international standards to the increasing internationalisation of business activities, does not fit in well with the hypothesis raised in Chapter 1 that internationalisation was unlikely to explain MNEs' preferences with regard to domestic policy issues. In the case of banking regulations, the six banks' internationalisation processes were clearly of significance. However, executives acknowledged that their banks' relatively new business focus on investment banking and asset management was also important. After all, the six banks internationalised business activities in order to expand their investment banking and asset management operations. In this sense, the strategic choice to embrace these two businesses gave the six banks by itself a natural interest in efficiently functioning capital markets. Since in this case internationalisation and business focus were closely intertwined, it is difficult to sort out which of the two factors came first and was in the end more important. As one interviewee noted, "it's a bit like the chicken and egg problem"<sup>89</sup>.

## Public Ownership of Banks

Public ownership of banks has been an important issue for the three German banks during the 1990s<sup>90</sup>. Chapter 6 will point out that the German banking sector has a relatively large share of state owned banks, which enjoy generous privileges. Most importantly, they benefit from an implicit public guarantee, which allows them to raise capital cheaply.

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<sup>88</sup> Interviews.

<sup>89</sup> Interview.

<sup>90</sup> In contrast to Germany, public ownership of banks has not been a contentious issue in Switzerland. Hirschowicz has noted that *cantonal* banks have stuck to their traditional role of accepting deposits and granting

Although Germany's commercial banks have long been complaining about what they regard as unfair competition, the issue acquired a new sense of urgency for them during the 1990s as some of the public sector banks – the *Landesbanken* – started building up investment banking and asset management divisions. This move precipitated sharp criticism from the three banks, which argued that the activities of Germany's state owned banks led to competition distortions and had negative ramifications for the single market<sup>91</sup>. In their view, the government should privatise the *Landesbanken*, or at least make them pay a market price for capital. In the word of one executive “public banks are a cancerous growth that had to be uprooted”<sup>92</sup>.

Explaining this preference through the explanatory framework of this study is, however, difficult, since it is hardly plausible to link the three commercial banks' preference for a level playing field to their internationalisation processes, their business focus or sectoral characteristics. Rather bank executives explained this preference as a natural concern that one was likely to encounter in every firm, which was facing competitors with obvious unfair competitive advantages.

### **The Six Banks' Economic Policy Preferences: An Analysis**

Judged by their public policy preferences, the three German banks have been strongly supportive of competition. All of them supported the GATS Agreement for Financial Services, welcomed the single market programme to establish a common market for financial services, advocated measures to deepen and broaden Germany's capital markets, and were relentlessly campaigning for a level playing field between Germany's commercial and public sector banks.

The three Swiss banks' preferences – at least prior to 1990 - were less clear cut. While they were also supporting open international markets for financial services, the three banks preferred “administered” competition in their home market. Through the *Swiss Bankers' Association* they operated a system of conventions which largely suspended the price mechanism. Citing a number of contestability and efficiency indicators, the three Swiss Banks and the *SBA* argued that these conventions actually enhanced the efficiency and the

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loans in the local area and have not attracted criticism from Switzerland's private banks. See Hirschowicz (1996), p. 10.

<sup>91</sup> See for example *FAGB Annual Report* (1998), pp. 44-47.

functioning of the Swiss banking sector. However, it was pointed out that these indicators were far from universally accepted. In other words, there was only a very thin line that divided the Swiss banks' preferences from rent-seeking. In fact, the Swiss government abolished the conventions in 1990 as they became increasingly incompatible with international norms and standards.

Turning now to an explanation of the six banks' preferences, the hypothesis that internationalisation was unlikely to be an important explanatory factor behind MNEs' policy preferences with regard to domestic policy issues, did not hold up as well as in the pharmaceutical sector. Despite the fact that the six banks were less internationalised than the six pharmaceutical MNEs, banks' internationalisation processes turned out to be of significance for their policy preferences.

Certainly this was the case with regard to the six banks' support for the GATS Agreement in Financial Services. It was pointed out that although the six banks internationalised their business operations only selectively, all interviewed executives nevertheless linked their support for the GATS Agreement to the increasing internationalisation of their business activities. All interviewees stressed the importance of bringing financial services within the jurisdiction of the WTO's dispute settlement mechanism and extending the MFN, Natural Treatment and Market Access principles to financial services. The importance of banks' internationalisation process in this context was, however, hardly surprising, since the GATS Agreement was a clear-cut trade policy issue, while all of the policy issues in the pharmaceutical sector were primarily domestic policy issues.

What was surprising, however, was that internationalisation was also an important factor behind the six banks' policy preferences with regard to reforms of domestic regulatory frameworks. It was noted that all six banks supported measures to broaden and deepen domestic capital markets and to adjust regulatory frameworks to international best practices, and that these preferences could, at least partly, be linked to banks' internationalisation processes. As banks expanded their business activities in international financial centres with well-functioning capital markets, they became increasingly keen to benefit from the same regulations in their home countries. Moreover, since the main bits of the investment banking and asset management business are located in a few financial centres, global capital markets became increasingly important for the six banks. Hence all of them supported the harmonisation of banking regulations on an international scale.

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<sup>92</sup> Interview.

A similar reasoning was also behind the three German banks' support for European directives for the establishment of a single market in financial services. It was noted that it was not the desire of the selected banks to establish a pan-European branch network that led them to support this initiative by the European Commission - Chapter 2 has pointed out that none of the selected banks was such harbouring ambitions - but rather German bank executives linked their preference for a common market in financial services to their desire for the harmonisation of regulatory and supervisory standards in order to increase the efficiency of Europe's capital markets<sup>93</sup>.

However, banks' business strategies were also important for an explanation of these preferences. Indeed, it appears not entirely clear which of the two factors was more important. After all, it was the strategy to embrace the securities business that led the six banks to strongly internationalise their investment banking and asset management activities and clearly, this business focus gave the six banks by itself a strong interest in efficiently functioning capital markets.

Finally, and similar to the pharmaceutical sector, it must be said that the proposed explanatory framework could not explain all of banks' preferences. First, it could not explain the three German banks' preference for a level playing field between commercial and public sector banks. Rather than being the result of bank- or sector-specific characteristics, this preference could more plausibly be explained as a concern likely to be voiced by every firm that was facing competitors, which benefited from unfair competitive advantages. Second, the explanatory framework could also not explain the three Swiss Banks' (pre-1990) preference for administered competition. Although the Swiss banks had a more substantial international business than the German banks in the 1980s (something that should lead them to support open markets) and had a broadly similar business focus, they favoured a set of conventions which largely suspended the price mechanism, while the German banks supported price competition. The following chapter will point out that Swiss competition laws are not distinguished by their stringency and that Switzerland has in the past often displayed a cartel-friendly attitude. This seems to suggest that national characteristics can also have an impact on the policy preferences of MNEs. It is, however, beyond the scope of this study to develop this point further.

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<sup>93</sup> Interview.

## Conclusion

The purpose of this chapter was to analyse the economic policy preferences of the selected MNEs. In line with the argument made in Chapter 1 that high levels of regulation were likely to encourage rent-seeking policies, neither the pharmaceutical MNEs' nor the banks' policy preferences were entirely straightforward: in the pharmaceutical sector, the six MNEs supported competition-promoting health care policies and a market-conforming regulatory framework for biotechnology regulations. Yet all of them also supported a maximum of intellectual property protection and the worldwide harmonisation of patent laws. Moreover, the German MNEs advocated the segmentation of EU health care markets along national lines in order to prevent parallel imports. It was noted that theoretical ambiguities and sectoral characteristics rendered it somewhat problematic to label these preferences downright rent-seeking, but clearly they are difficult to accommodate with free price competition.

In the financial services sector, all six banks supported open international markets, the broadening and deepening of domestic capital markets and the adjustment of domestic regulatory frameworks to international norms and standards. Yet the Swiss banks, at least prior to 1990, supported a regime of conventions, which suspended the price mechanism for a number of banking services. While also not entirely free from ambiguities, it appears difficult to label this preference for administered competition anything but rent-seeking. Although it has often been argued that performance indicators showed that Switzerland's banking sector was perfectly efficient, innovative and open, it has also been pointed out that the literature was far from unanimous when it came to the accuracy and reliability of these indicators. Only the German banks disproved the hypothesis that high levels of regulation were likely to encourage rent-seeking behaviour: all three unambiguously supported competition-promoting policies.

Turning to an explanation of these preferences, Chapter 1 argued that internationalisation was unlikely to explain MNEs' preferences with regard to domestic policy issues. While the traditional explanatory logic that explained MNEs' trade policy preferences as a result of the extent and nature of their internationalisation process certainly remained valid, it was suggested that an analysis of domestic policy issues required two additional explanatory factors: MNEs' business focus and sectoral characteristics. Put differently, the goal of the study was not to disprove existing theories about MNEs' trade policy preferences but rather to

go beyond them. Pharmaceutical MNEs and banks appeared to make good case studies to explore the importance of internationalisation for MNEs' policy preferences since MNEs from these two sectors differ significantly in the extent and nature of their exposure to international markets.

In the pharmaceutical sector the findings were largely consistent with the hypothesis that internationalisation was not important for MNEs preferences with regard to domestic policy issues. It was shown that the business focus of the six MNEs and sectoral characteristics went a long way towards explaining their policy preferences with regard to health care policies, intellectual property rights and parallel imports. Only with regard to the worldwide harmonisation of patent laws was the six MNEs' internationalisation process of importance. Moreover, the analysis discovered one important anomaly: despite high levels of internationalisation - which according to the literature should lead MNEs to support free trade - the three German MNEs supported market-closing policies for drug re-imports from other European countries. It was shown that sectoral characteristics could explain this anomaly.

In the financial services sector, the findings did not entirely vindicate the study's hypothesis. Although the six banks were less internationalised than the pharmaceutical MNEs, their internationalisation processes were an important factor behind their policy preferences. In the case of the GATS Agreement for Financial Services this could be expected, since this was a clear-cut trade policy issue. However, internationalisation also proved to be of importance for the six banks' policy preferences with regard to reforms of the domestic regulatory frameworks. While banks' business focus was also a significant factor in this context, the findings nevertheless showed that the argument that internationalisation was unlikely to be of importance for MNEs' domestic policy preferences has been a bit premature.

# 4

## **Economic Policy-Making in Germany and Switzerland**

This study is, however, not only about MNEs' preferences but also about their political influence and, as has been argued earlier, the former is unlikely to provide by itself a reliable basis for explaining, let alone predicting, the latter. First, as Chapter 1 has argued, institutions matter. In many cases they determine the nature and degree of firms' access to policy-making circles and thereby distribute power. Second, as has also been argued in Chapter 1, circumstances matter. Regardless of whether one relies on interests (as the rational choice literature does) or institutions (as the corporatist literature does) as the basis for explaining policy outcomes, the circumstances under which policy-making takes place cannot be ignored since they are likely to have an impact on governments preferences, the extent of opposition from other interest groups and the degree to which MNEs can use their internationalisation process for political leverage. In other words, they have an impact on institutions and perceptions of self-interest and are thus likely to condition the political influence of MNEs. What is thus needed is an analysis that brings the various explanatory approaches together – a study that focuses on a selection of policy issues and then determines for each case separately whether it was MNEs' interests, their institutional linkages to the policy-making process, the impact of circumstances or some combination of the three factors which best explains the actual policy outcome. On this basis, it should then be possible to suggest some broader conclusions about MNEs' political influence. This chapter will provide the basis for such an analysis. It will examine the institutional structure of the German and Swiss economic policy-making process and analyse the economic and political circumstances under which policy-making took place during the second half of the 1980s and the first half of the 1990s. Together with MNEs' interests – which were analysed in the previous chapter – Chapters 5 and 6 will then focus on a sample of policy issues in the pharmaceutical and the financial services sector and draw the various pieces together.

## Germany

### Institutional Structure of the Economic Policy-Making Process

The institutional structure of the German economic policy-making process has featured in numerous studies, and the findings are well accepted in the literature. Essentially it is a system of economic policy-making, which includes a relatively large number of governmental and non-governmental actors and which is strongly geared towards consensual decision-making<sup>1</sup>. Writing in the 1960s, Andrew Shonfield coined the term “organised capitalism”.

The need for consensual decision-making arises from the limited executive powers of the German government and from the inclusion of numerous non-governmental actors in the economic policy-making process – in other words, from high levels of decentralisation. While the German government is essential for bringing the various actors together, its executive powers are otherwise significantly constrained by numerous checks and balances: These include the federal structure, which gives the *Länder* the right to participate in policy making through the *Bundesrat* (the upper house of parliament, which can block or even reject bills passed by the lower house, the *Bundestag*) and which leaves *Länder* governments significant scope for pursuing their own industrial policies – something that, as Pohle has argued, can either undermine or reinforce federal economic policies<sup>2</sup>. Scharpf has pointed out that this system of permitting the states to collectively exercise a degree of influence on federal policy was in an international comparison “absolutely extraordinary”<sup>3</sup>.

Further checks on the executive include a number of semi-autonomous regulatory agencies, the federal constitutional court, which has acquired a reputation for stringent judicial reviews of government policies’ and a fiercely independent central bank. These parapublic institutions are often seen as an important factor behind Germany’s political stability. Groser, for example, has argued that they have provided a key to a quiet and

<sup>1</sup> See for example Katzenstein (1987) and (1989), Berghan and Karsten (1987), Sally (1995) and Shonefield (1965). For a comparative analysis that contrasts German economic organisation to that found in other countries see Hart (1992) and Soskice (1990).

<sup>2</sup> See Pohle (1995). Paterson and Webber (1986) have argued that Germany’s federal system has reinforced a comparatively low degree of political polarisation and a predominantly co-operative style of opposition, since in Germany’s political system no major party is ever completely out of office and devoid of political influence.

<sup>3</sup> Scharpf (1990), p. 570.

harmonious process of formulating policy, while Katzenstein has credited them with helping to reinforce the peace that has prevailed between the social forces of the Left and Right since 1945<sup>4</sup>.

However, German legislation not only confers restricted powers on public authorities, but also requires that these powers be only exercised in consultation with major societal interests. Accordingly, economic policy-making networks encompass not only various federal and state agencies, but also numerous non-governmental actors. Most prominent among them are the associations of business and labour.

In contrast to the dispersion of state power among competing institutions, power in Germany's private sector is thoroughly centralised. The business community is organised into three peak associations. The Employers' Association (*Bundesvereinigung der Deutschen Arbeitgeberverbände or BDA*) represents employers in collective wage bargaining rounds, the Chamber of German Commerce (*Deutscher Industrie-und Handelstag - DIHT*) represents the interests of small interests and crafts on a regional basis and the Federation of German Industry (*Bunbesverband der Deutschen Industrie - BDI*) represents the overall economic policy objectives of German business. Additionally there are numerous sectoral associations, which deal with more technical and sector-specific issues. Similar to the business community, power is thoroughly centralised in the labour domain. Seventeen unions organise workers along industry lines under the umbrella of the Federation of German Trade Unions (*Deutscher Gewerkschaftsbund - DGB*). In addition, there are independent unions for white-collar employees and civil servants.

These decentralising and centralising features of the German economic policy-making process are linked at various levels through numerous institutions. For example, the trade associations and unions are directly represented in parliamentary committees dealing with matters of interest to them and regulations and laws assure these groups access to the state bureaucracy. Katzenstein, among others, has observed that as a result, economic policy-making is carried out through negotiations between the government and organised economic interests in a process of mutual give and take<sup>5</sup>. Moreover, he has noted that this system of government multiplied potential sources of veto and made large-scale departures from established policies an improbable occurrence. Instead, policy change was likely to be incremental even when a new government was voted into office<sup>6</sup>.

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<sup>4</sup> See Groser (1983) and Katzenstein (1987), p. 58.

<sup>5</sup> See Katzenstein (1987) and (1989), pp. 307-353.

<sup>6</sup> See Katzenstein (1987), pp. 15, 35, 81.

Another important component of Germany's system of organised capitalism is the concept of *social partnership*: negotiated agreements between the employer associations and labour unions on issues ranging from wage bargaining to vocational training<sup>7</sup>. In addition, German law provides for elected workforce representation on the supervisory boards of firms with five hundred or more employees and in the works councils for each workplace with five or more employees. Since in most cases works councillors and supervisory board members of the workforce are also union members, Germany's system of industrial relations provides also for a firm-based level of union influence and labour-management negotiations<sup>8</sup>.

A further component of Germany's organised capitalism is the financial system, which was for decades dominated by a small number of universal banks, the three largest being Deutsche Bank, Dresdner Bank and Commerzbank. In order to rebuild rapidly after World War II, German policymakers re-established a banking system based on a nineteenth century model that could allocate large amounts of capital quickly and effectively. Unlike the American system, the German banking system is not restricted by detailed regulations that separate financial functions. German banks are free to own stock, sit on the boards of directors, vote large numbers of proxy shares, and make long-term loans to most firms, large and small<sup>9</sup>. Shonfield has pointed out that the link between great institutional power and the investment needs of individual firms has made the banks major actors in the maintenance of the country's overall economic health. However, during the following decades, German industry increasingly evolved from the earlier "one firm – one bank" (house bank) relationship toward a looser system of finance<sup>10</sup>.

It is often argued that the interests of German business feature prominently in economic policy making networks<sup>11</sup>. Katzenstein has pointed out that German business was largely credited for the economic miracle of the 1950s and, as result, irrespective of which party held the reins of power, business enjoyed a pre-eminent place Germany's political life<sup>12</sup>. Indeed, the linkages between business and the state appear to be particularly strong. While the trade associations certainly lobby on behalf of their members in order to extract favourable policies

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<sup>7</sup> See Turner (1997), p. 4.

<sup>8</sup> See for example Turner (1997), p. 4f and Auer (1997), pp. 16-19. For the centrality of this "dual system" (co-determination at the plant level and industry-wide collective bargaining) to an understanding of German industrial relations see Thelen (1991).

<sup>9</sup> See Allen (1997), p. 144.

<sup>10</sup> See Oberbeck and Baethge (1989) and Esser (1989).

<sup>11</sup> See for example Sally (1995).

<sup>12</sup> Katzenstein (1987), pp. 24f.

from the state, they also perform a number of other roles, which distinguish them from other interest groups. As an official from the BDI has argued,

“association staff often provide information and expert advice to the state, help implementing policies, offer self-regulation in order to fend off legal regulation by the state, conduct trial runs of proposed legislation in member firms, and make their members behave ‘responsibly’ in specific policy areas”<sup>13</sup>.

Streeck has pointed out that the peak associations help to compensate for the state’s lack of direct access to the complexities of economic realities. He has argued that by doing so, the trade associations perform an essentially public function without being formally part of the state apparatus<sup>14</sup>. Analysing German economic policy-making in the 1980s, Streeck concluded that

“the picture that emerged ... was one of the state so continuously soliciting expert advice and other ‘auxiliary services’ from associations that this amounted to a ‘forcible devolution’ to them of what rightly should be public tasks and responsibilities, and in effect to an expropriation of their organisational resources”<sup>15</sup>.

This assessment appears to hold true in the 1990s. According to an official from the Ministry of Economics, it would be not be accurate to think of Germany’s trade associations as mere pressure groups; rather they devote much of their efforts to the assistance of government. In return, so the official, “there is a tendency on part of the state to confer on them public status and responsibilities”<sup>16</sup>.

It is often argued that unification did not alter in any substantial way these institutional arrangements<sup>17</sup>. Webber, for example, has argued that the federal government has remained weak and was often forced to negotiate with state governments from a position of weakness. Although the new eastern states were dependent on financial transfers from the West, there has been no “hollowing out” of the co-operative federalist system<sup>18</sup>. Analysing economic

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<sup>13</sup> Interview.

<sup>14</sup> See Streeck (1983), p. 269.

<sup>15</sup> Ibid., p. 268.

<sup>16</sup> Interview.

<sup>17</sup> See for example Sally and Webber (1994).

<sup>18</sup> Webber (1997), p. 247. In the immediate aftermath of unification it was often forecasted that the integration of five economically and financially weak eastern states would enable the federal government to play off a

policy-making in the early 1990s, Sally and Webber have argued that the comparatively close and intensive relationship of government, business and labour continued to distinguish the post-unification republic from other big democratic capitalist states; in their view, co-operation and compromise were likely to remain more pervasive in the politics of the unified Germany than confrontation and polarisation<sup>19</sup>. In similar vein, Auer has emphasised the capacity for continuing negotiated problem solving within the basic *social partnership* model<sup>20</sup>.

Indeed, there has been evidence for a renaissance of neo-corporatist initiatives. Citing the example of the newly set up employment companies (*Beschäftigungsgesellschaften*) to mitigate the effects of mass redundancies in the aftermath of unification, Webber has argued that within a year of unification, the traditional German pattern of neo-corporatist crisis management had begun to reassert itself<sup>21</sup>. Moreover, Turner has observed that the institutions of *social partnership* were successfully established in Eastern Germany in an extraordinarily short period of time (1990-1994)<sup>22</sup>. However, the most visible expression of continued corporatist activities were arguably the negotiations over a “Solidarity Pact” during the winter of 1992-1993. Through this pact, Chancellor Kohl hoped to persuade the unions to exercise wage moderation in the West - and to revise their policy of raising eastern wages to western levels - and the business associations to make sacrifices, on behalf of their members, which would enable the package to be sold politically as “equitable”<sup>23</sup>. Although the initiative failed to persuade the unions and the business associations to make substantial concessions, it has been interpreted as accelerating a trend toward neo-corporatist crisis management at the level of the states<sup>24</sup>. In fact, Webber has argued that

“four years after unification, there was not less but more neo-corporatist interaction among

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majority of weak (western as well as eastern) states dependent on federal financial support against a minority of financially strong states and thus lead to a greater centralisation of power. See Scharpf (1990), pp. 579-587, Hesse and Renzsch (1990) and Leonardi (1991). According to Webber (1997, p. 236) this has, however, not happened. Rather the German states have displayed a strong capacity to maintain a common front against the federation. They have, for example succeeded in securing several changes in the Basic Law improving their policy-making powers.

<sup>19</sup> Sally and Webber (1994), pp. 39f.

<sup>20</sup> Auer (1997).

<sup>21</sup> Webber (1994), p. 165.

<sup>22</sup> Turner (1997), p. 113.

<sup>23</sup> See Sally and Webber (1994).

<sup>24</sup> See Webber (1994), p. 168. Saxony, for example, created multipartite committees containing government, business associations, and union representatives to identify “core” firms worthy of state financial support – a model that has been emulated in all other eastern German states. See Webber (1994), pp. 168f.

government, business and labour than in the Federal Republic during the 1980s”<sup>25</sup>.

In short, it appears that one can make a plausible case that Germany’s system of “organised capitalism” has been alive and well during the 1990s.

However, such an argument appears to be overly simplistic. In fact, the view that Germany’s institutional arrangements have not changed during the last decade has not been unchallenged. A number of authors have argued that German corporatism – understood as the integration of the major producer interests in macro-economic policy formation – has been already on the wane during the 1980s<sup>26</sup>. An often-cited example during the 1990s to support this hypothesis was the unification process, during which there was an abrupt decline in the government’s propensity to consult and integrate the major interest organisations<sup>27</sup>.

In addition one can point to a number of other developments that could be interpreted as first signs of cracks in Germany’s institutional structure. A number of interviewees, for example, argued that with the worsening of economic framework conditions many firms began to feel no longer adequately represented by their sectoral or peak associations and started to by-pass them<sup>28</sup>. Not only have companies like Veba, Daimler Chrysler or BMW set up their own offices in Bonn and Berlin, but as Kessler has noted, one can also observe a growing trend for head hunting current members of parliament, and for employing ex-members, in order to use their contacts to lobby on behalf of the company. Moreover, he has pointed out that alongside the “traditional” representatives of commercial interests, independent professional lobbyists were establishing themselves in Bonn and Berlin who were hired by companies for specific projects<sup>29</sup>.

Moreover, collective wage bargaining has become less comprehensive. The *BDI* has noted that while the peak associations tried for years unsuccessfully to make Germany’s wage bargaining process more flexible, individual firms negotiating directly with their workers and employees proved to be a lot more effective<sup>30</sup>. In many cases, factory councils began to ignore the one-size-fits-all collective wage agreements negotiated at the national level and accepted innovative pay and working-time deals that were specific to the particular

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<sup>25</sup> Webber (1997), p. 233.

<sup>26</sup> See Esser (1986), Padgett (1992), p. 203 and Hancock (1989), pp. 134-141.

<sup>27</sup> See for example Lehmbruch (1992), pp. 45f.

<sup>28</sup> Interviews.

<sup>29</sup> See Kessler (1996), pp. 35-39. Webber (1997, p. 248) has noted that starting in the mid-1990s, a growing number of firms were resigning from the employers’ organisations.

<sup>30</sup> See *BDI* (1997). Herrigel (1997) has highlighted rigidities in work organisation that interfere with a necessary work reorganisation of German industry.

conditions of individual plants. For example, workers in the engineering and car industries have accepted longer working hours and more varied shift patterns. Several companies now use "credit time accounts" that allow managers to increase working hours during periods of strong demand, in return for time off later in the year. In fact, these agreements have proven so successful that several large companies have split their operations into smaller units to make it easier to negotiate plant-by-plant wage deals<sup>31</sup>. Several authors have linked these developments to a decline of the bargaining power of the unions' vis-à-vis employers as a result of firms' increasing internationalisation<sup>32</sup>.

In short, there appears to be both continuity and change in Germany's institutions. Judging at a general level if and how these processes have affected firms' political influence appears to be, however, difficult. So rather than taking sides in the debate, this study will in the following chapters determine for each policy issue separately, whether and how institutions were important for an explanation of actual policy outcomes and the six MNEs' political influence.

Finally, within the context of a comparison between economic policy-making in Germany and Switzerland – two states with institutional structures more renowned for their similarities than their differences – it should also be pointed out that German economic policies have in the past been strongly guided by a liberal tradition. The roots of this tradition can be traced back to the concept of the "social market economy" - the term coined by Ludwig Erhard as the political label for the economic reform programme to rebuild the German economy after World War II. Central to this concept was the belief that the state ought to limit its role in the economy to setting up and maintaining the institutional framework of a free economic order and refrain from all interventions in the price mechanism through, for example, anti-cyclical policies, subsidies, or tax breaks<sup>33</sup>. The adjective "social" was used primarily to distinguish the concept from simple laissez-faire capitalism, which in the eyes of the founding fathers of German neo-liberalism, paid too little attention to government activity<sup>34</sup>. Tietmeyer has pointed out that the adjective "social" does, however, not legitimise the creation of an extensive welfare state. Rather it refers to a free economic order embedded in a legal and

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<sup>31</sup> On average, German factories now operate for 71.8 hours a week, compared with 60.6 in 1984. See "Germany's new shop window" *Financial Times* Nov. 20 1998. See also "Restructuring corporate Germany" *The Economist* Nov. 21 1998 and "The changing face of German unions" *The Economist* Dec. 5 1998.

<sup>32</sup> See Mahnkopf (1991 and 1993), Streeck (1991 and 1997) and Mosley (1990). One official at the BDI has argued that as German companies have shifted production abroad to cut their wage bills, employers have been able to side step the unions and negotiate directly with their factory councils.

<sup>33</sup> See Sally (1996).

<sup>34</sup> A state of affairs popularly characterised by the term "night-watchman state".

institutional framework that ensures that competition is durably maintained<sup>35</sup>. As Ludwig Erhard put it, "The concepts of free and social are congruent (...); the freer an economy is, the more social it is, and the greater will be the macroeconomic utility created"<sup>36</sup>. Although much of this liberal streak in German economic policy-making had disappeared by the 1990s (see below), its legacy continues to linger in certain policy areas, such as for example competition policy<sup>37</sup>.

Having outlined the main structural features of the German economic policy-making process, it is now time to analyse recent economic and political developments in order to provide the context in which policy-making took place during the second half of the 1980 and the first half of the 1990s.

### **Economic and Political Circumstances**

Germany's inclusive policy-making process has often been praised for its ability to combine economic growth with social cohesion. Particularly political scientists in the 1980s often proclaimed that Germany's consensual economic policy-making system was capable of combining the dynamism of free markets with social stability by engineering an adjustment process that allowed for structural change while at the same time minimised social disruption<sup>38</sup>. Seen from this perspective, Germany's economic performance over the last decades was usually a celebration of the virtues of an export-oriented economy with excellent industrial relations and reasonable macroeconomic policies<sup>39</sup>.

From a mid-1990s' point of view, however, this interpretation does not look entirely convincing. In view of record unemployment and only modest growth rates (see below), a different interpretation appears to be also plausible. In fact, Giersch et al. have pointed out that Germany's declining economic performance was not a recent phenomenon but rather a process that began three decades ago when underneath the surface of export surpluses and social cohesion, the largely liberal economic order that was established in the post-war years under Ludwig Erhard started to become increasingly incompatible with the German

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<sup>35</sup> Tietmeyer (1999), p. 6.

<sup>36</sup> Erhard (1966), p. 320. For the complementary nature of economic laws and ethical postulates see Tietmeyer (1999), pp. 127-136.

<sup>37</sup> See Paque and Soltwedel (1993).

<sup>38</sup> See for example Katzenstein (1987), p. 45.

<sup>39</sup> See for example Katzenstein (1989).

government's dependence on intermediary powers<sup>40</sup>. In this view, rather than acting impartially, the German government became increasingly interventionist in order to engineer economic outcomes that were deemed socially desirable and to satisfy a proliferating number of interest groups. Tietmeyer has argued that these interventions lowered the capacity of the German economy to adjust to a structurally changing world economy and, with the usual time lag, resulted in declining economic growth rates and rising unemployment<sup>41</sup>. Indeed, it seems that a plausible case can be made to show that government activities steadily increased over the last decades.

Tietmeyer has noted that the reconstruction boom of the 1950s and early 1960s was followed by a belief that the economy could be fine-tuned<sup>42</sup>. This manifested itself most visibly in the 1967 Law on Stability and Growth, which required the government to simultaneously achieve price stability, full employment and economic growth. It was also during this period that the state increasingly intervened in the economy to secure employment and a "just" distribution of income<sup>43</sup>. Färber has argued that these tendencies towards structural conservation became more pronounced during the 1970s. As a response to growing unemployment after the 1974-1975 recession, the government set up numerous subsidy programmes, particularly in coal mining, fisheries, agriculture, shipbuilding and steel<sup>44</sup>.

The change from a centre-left to a centre-right government in 1982 did not change this overall trend. Although some progress was made – the tax burden fell as a share of output and the government reduced the scale of its ownership in state-owned enterprises - little was done to reduce public spending and to reform social security systems<sup>45</sup>. In the aftermath of German reunification in 1990, government interventions increased strongly as the German government responded to the challenges of re-unification with a historically unparalleled spending programme; transfers in the period from 1991 to 1995 have been estimated at DM 986bn<sup>46</sup>. While much of this money was invested in the upgrading of East Germany's

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<sup>40</sup> Giersch et al. (1992).

<sup>41</sup> Tietmeyer (1999), p. 75.

<sup>42</sup> *Ibid.*, p. 25.

<sup>43</sup> In its 1968 *Principles of Sectoral and Structural Policy*, the Economics Ministry gave for the first time consideration to the need to slow down the pace of some adjustment processes in order to secure jobs and income levels.

<sup>44</sup> See Färber (1989).

<sup>45</sup> See Tietmeyer (1999), p. 33.

<sup>46</sup> See Heilemann and Rappen (1996).

infrastructure, a large share was also spent on the modernisation of production structures and on creating investment incentives – in other words, on second-guessing the market<sup>47</sup>.

Moreover, defying economic logic, the Kohl government pushed through a currency union at a rate primarily intended to preserve the savings of East Germans<sup>48</sup>. The “side effect” was that East German goods became largely uncompetitive and the overall result was a large-scale industrial slump<sup>49</sup>. Despite substantial subsidies, industrial production in the former East Germany fell by more than 50 per cent in the six months after the currency reform and, by 1992, the official unemployment rate had risen to about 18 per cent<sup>50</sup>. Subsidies during this period increased strongly; while in 1989, subsidies amounted to 5.4 per cent of GDP, this figure had by 1993 risen to 9.2 per cent<sup>51</sup>. Moreover, tax breaks were increasingly substituted with cash handouts. While in 1985 some 40 per cent of subsidies were granted as tax breaks, this figure had by 1993 declined to 20 per cent. Klodt and Stehn have pointed out that this should be interpreted as a thoroughly negative development as it implied a further loss of impartiality on the part of the state (tax breaks are usually extended to sectors, while cash hand-outs centre on one specific company), likely to lead to higher opportunity costs as companies increased their lobbying efforts<sup>52</sup>.

A look at the numbers confirms the picture of a state that has gradually extended its reach over the economy. Public sector share of GDP fluctuated between the mid-1970s and mid-1990s between 45 and 50 per cent, after less than 30 per cent in the 1950s, and 30 to 40 per cent in the 1960s (see figure 4.1)<sup>53</sup>. Both personal income and corporate tax rates are among the world’s highest (the top rates are 53 and 45 per cent, respectively) and non-wage contributions amount to over 42 per cent of gross wages - up from 36 per cent in 1989 and 26.5 per cent in 1970<sup>54</sup>. Moreover, it has often been pointed out that regulations proliferated strongly during the last decades<sup>55</sup>. In the 1997 Economic Freedom Report published by the Fraser Institute, Germany ranked 25<sup>th</sup> (tied with Argentina, Bolivia and Chile), down from its

<sup>47</sup> Giersch et al. have estimated that investment subsidy schemes and the like lowered the cost of investing in Eastern Germany by about 20 to 30 per cent. See Giersch et al. (1992), p. 270.

<sup>48</sup> For the effects and objectives of the currency reform see Allen (1997), pp. 148f.

<sup>49</sup> East German marks were exchanged for the D-mark at a one for one rate for wages, pensions and rents. Most other domestic financial assets and liabilities were converted at a rate of 2 East mark = 1 DM with the notable exception of the savings of GDR residents, which up to certain limits were converted at a one for one rate.

<sup>50</sup> Including people on make-work schemes, the rate of unemployment was estimated to have been as high as 30 per cent. See Giersch et.al. (1992), p. 270. For various extended measures of underemployment in Eastern Germany from 1990 to 1992 see Klodt and Paque (1993), pp. 14ff.

<sup>51</sup> See Klodt and Stehn (1994), pp. 188f.

<sup>52</sup> Ibid., p. 189.

<sup>53</sup> See BDI (1997), p. 8.

<sup>54</sup> Ibid., pp. 8-10.

<sup>55</sup> See for example “Birth of the Berlin Republic” *Financial Times* Survey Nov. 10 1998; “Der Paragraphenwut

14<sup>th</sup> place ranking in 1990 and 10<sup>th</sup> place finish in 1980<sup>56</sup>. In short, while the last decade has certainly also seen important liberalisation measures (i.e. the Single European Act and the privatisation of a number of state owned enterprises) one can still make a case that German governments became increasingly keen to engineer economic outcomes. As Hans Tietmeyer

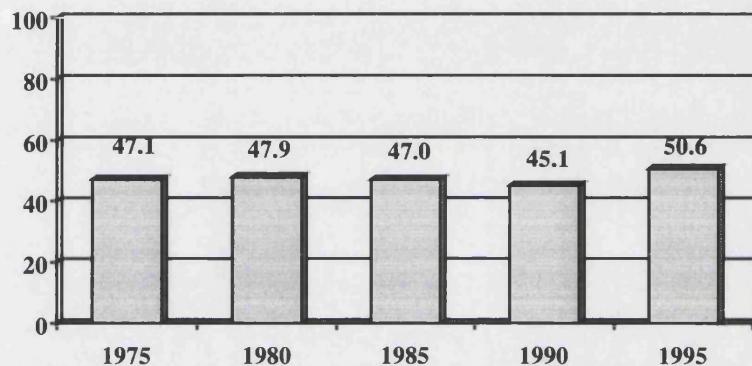


Figure 4.1: Government Expenditure as a Percentage of GDP

Source: World Economic Freedom Report 1997, p. 98.

has argued, “policy-makers have increasingly misused the concept of the Social Market Economy by emphasising the adjective ‘social’ in order to legitimise activities or demands that are incompatible with market requirements”<sup>57</sup>. Peters has pointed out that as structural change began to threaten jobs, framework oriented economic policies gave increasingly way to structural intervention policies with the aim of preserving the status quo<sup>58</sup>, and Donges and

tötet den Unternehmergeist”, *Die Zeit*, April 4 1997 and “Wirtschaftsblunder”, *The Economist*, Feb. 1 1998.

<sup>56</sup> See Gwartney and Lawson (1997), p. 99. Sponsored by a network of research institutes around the world, the Economic Freedom of the World Project has since 1975 published economic freedom ratings for a growing number of countries around the world. The ratings for each country are arrived at by judging its performance under a set of 17 attributes which, when combined, make up an index of economic freedom. The attributes are grouped under four headings: money and inflation, government operations and regulations, takings and discriminatory taxation, and restraints on international exchange. For limitations and weaknesses of the index see Henderson (1998), pp. 124f.

<sup>57</sup> Tietmeyer (1999), Foreword.

<sup>58</sup> Peters (1996), p. 189.

Schmidt noted that these interventions almost always had the goal of securing the income and employment of particular groups against domestic or international competition<sup>59</sup>.

It should also be mentioned in this context that economic growth declined steadily over the last decades and was accompanied by increasing levels of unemployment (see table 4.1). In 1997, unemployment in the unified Germany stood at a post-war high of 4.8m, corresponding to 12.5 per cent of the German labour force.

	1960-1973	1973-1980	1980-1989	1990-1997
Change in real GDP	4.4	2.2	1.9	2.1
Unemployment Rate	1	4.9	8.5	9.5

Table 4.1: Economic Growth and Unemployment Rate in the period from 1960-1997.

Sources: Giersch et al. (1992), p. 2f, 10f; BDI (1997), pp. 8

The *Sachverständigenrat* (the main group of economic advisors) has pointed out that since the 1970s an unemployment base has developed which has grown with every recession and which has not been significantly reduced even in periods of strong economic growth<sup>60</sup>. Consequently, as Klodt and Stehn have argued, cyclical measures to go back to full employment are unlikely to work. Instead the problems have their roots on the supply side in institutional impediments to competition, such as retarding regulations, high taxes and subsidies, which have prevented the German economy from adjusting and benefiting from a changing international division of labour<sup>61</sup>. Particularly negative has been the influence of Germany's system of centralised pay bargaining under which unions and employers set wages across whole industries, thereby ignoring differences in productivity so that, for example, computer engineers and shipbuilders both get the same pay rise. This rigid wage

<sup>59</sup> Donges and Schmitt (1993), p. 124.

<sup>60</sup> Quoted in Klodt and Stehn (1994), p. 204. See also Donges and Schmidt et al. (1988).

<sup>61</sup> Klodt and Stehn (1994), p. 202.

structure made it difficult for the German economy to adjust to the economic re-evaluation of labour, a development driven not least by the process of globalisation. As a result, many workers were priced out of jobs<sup>62</sup>.

During the early 1990s, the deteriorating performance of the German economy began to lead to serious doubts about Germany's attractiveness as a production location and its ability to compete for internationally mobile capital. Since the mid-1970s capital outflows have significantly exceeded inflows of internationally mobile capital<sup>63</sup>. Tietmeyer has pointed out that while for many years commentators frequently praised the German model as setting a good example for other countries, doubts have arisen as to whether Germany's economic system is still competitive in the age of globalisation. As he put it,

“Beginning in the early 1990s, Germany began to experience something new. While there have always been people who have doubted whether the German economic system is fair or humane, for decades there has been virtually no doubt about the performance of the German economy. Unfortunately this is no longer the case. As seldom before, doubts have arisen as to whether the current mix of market forces and government intervention is able to master the challenges facing Germany in an age of globalisation. Indeed, some foreign observers have already talked about the decline of ‘Rhineland capitalism’ and of the crisis besetting Germany's consensus society”<sup>64</sup>.

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<sup>62</sup> See Tietmeyer (1999), pp. 73-79. The conclusion that labour has been bearing an increasing share of the costs that are associated with increasing economic openness has become a common theme in the analyses of social scientists. See for example Borjas and Ramey (1995). Often in such analyses, the declining relative position of labour is explained by effects of international trade. Imports, so the argument often goes, embody the labour provided by the exporting country and - following a hallowed theorem of international trade - such imports inevitably pull the wage rates of the importer down toward that of the exporter. However, the proposition that foreign trade has been responsible for the declining relative position of labour has drawn sharp protests. See for example Wood (1995) and Lawrence (1994). Some point out that international trade by itself is not sufficient in volume to have created changes in the wage levels of the rich countries. See for example Krugman (1995). Others emphasise that the big shifts in income since the 1970s have taken their toll on blue collar labour rather than labour as a whole; and, basing their conclusions on US data, they attributed that shift to technological changes in production or to immigration from the poor countries to the rich. See for example Borjas, Freeman and Katz (1997).

<sup>63</sup> See for example Klodt and Stehn (1994), p. 2 and Kahrmann and Sauerland (1991). The debate about the competition between production locations is often discussed in terms of nations competing against each other in the same way as companies do. See for example Thurow (1993). This is misleading. The international economy does not pit states against each other, but rather locks them in an international division of labour that can benefit all countries. It is not a zero-sum game. See for example Krugman (1994). What is, however, true is that nations compete for internationally mobile capital. In any given year, there is only a fixed pool of FDI available and more FDI for one country means inevitably less for another. Competition in this area is highly relevant not least because new approaches in growth theory have shown that a nations' long term growth rate is positively influenced by the amount of investment undertaken as increases in a country's capital stock raises the productivity of other production factors, which in turn also raises wages. See for example Romer (1986, 1989).

However, increasing state activities appear to be only half of the story, if one seeks to describe the circumstances under which German economic policy-making took place during the period from 1985 to 1995. While increasing government intervention has certainly been a major characteristic, there has also been another important development – the proliferation of highly vocal and well-organised interest groups<sup>65</sup>. In line with Mancur Olson's prediction that stable societies will over time produce an increasing number of distributional coalitions aligned against change<sup>66</sup>, Germany has seen over the last decades a proliferating number of organised interest groups whose main goal appears to have been the preservation of the status quo. Klodt and Stehn have pointed out that Germany's problem was that its traditional advantages - monetary stability, a skilled workforce, social peace, well-developed infrastructure, political stability - could now be found in a lot of other countries while at the same time Germany failed to tackle and reform its well-known weaknesses – high taxes, high labour costs, inflexible wages and high levels of regulation<sup>67</sup>. It does not appear far-fetched to link this failure to adjust, at least partly, to the political activities of interest groups. In fact, a number of authors have noted that much needed structural reforms have often been stymied because of the stubborn unwillingness of large parts of society to relinquish acquired rights and privileges<sup>68</sup>. In similar vein, a BDI official observed that

“German interest and pressure groups these days operate on the premise that the fastest way to advance the well-being of their members is not to compete in the market but rather to lobby for transfers of various kinds from non-members. These may not always be in the form of cash or services, but increasingly these days manifest themselves as regulations. Usually under the banner of ‘fairness’, which has become an infinitely elastic principle, or perhaps in the name of ‘sustainable development’, or some other worthy cause, ever more people devote their best efforts to transfer-seeking rather than to economic production”.

Echoing this last point, interviewees often stressed the rise of strongly anti-market attitudes among a plethora of “new” interest groups. Particularly environmental groups were singled

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<sup>64</sup> Tietmeyer (1999), p. 55.

<sup>65</sup> For an explanation of how interest groups come to be formed and why, once formed, they are extremely hard to disperse see Olson (1965).

<sup>66</sup> See Olson (1982).

<sup>67</sup> See for example Klodt and Stehn (1994) and Klodt and Schmidt (1989).

out for their activities, which frequently involved the condemnation of or disregard for market processes and a bias towards collectivist ways of thinking and regulatory programmes<sup>69</sup>. Prominent examples for such activities from the last decade included regulations for food safety and genetic engineering (see Chapter 5). The result of these developments was that Germany's quiet and consensual policy-making process turned during the 1980s and 1990s often into distributional conflicts and acrimonious discussions between the advocates of change and the advocates of the status quo.

This conflict has been particularly visible in the debate about the need for economic reforms in the face of globalisation. On one side, the business community - supported by most economists and think tanks – have relentlessly stressed the need for deregulation and liberalisation to remain competitive in a structurally changing world economy and have emphasised the benefits of increased trade, cross-border investments and technological progress<sup>70</sup>. From their point of view, the cause of Germany's economic problems has not been globalisation itself, but rather sclerotic structures that reduced flexibility and made it impossible for the German economy to benefit from a changing international division of labour. These preferences were, however, strongly opposed by a diverse group of organised interests ranging from labour unions, environmental groups and the church to self-styled economists and other vested interests. In their view, globalisation itself is the root cause of the problem since it inevitably will destroy more jobs than it creates, widen income inequality, reduce the ability of governments to provide welfare services and – if not checked by various forms of government intervention – exacerbate poverty and lead to social exclusion. The result of this increasing politicisation of economic policy-making has been large-scale political gridlock<sup>71</sup> and somewhat cooler relations between industry and government as the business community grew increasingly impatient with Germany's incapacity to adjust to changing economic realities<sup>72</sup>. Significant in this context has also been the corporate restructuring that was visible during the 1990s in many of Germany's large export-oriented companies (and also in related small and medium-sized companies). While policy-makers were slow and cumbersome to react to a structurally changing world economy, many of Germany's companies had to quickly restructure their business operations in order to

<sup>68</sup> See for example Tietmeyer (1999), pp. 33f. and *BDI* (1997).

<sup>69</sup> Interviews.

<sup>70</sup> See for example *BDI* (1997).

<sup>71</sup> Often cited in this context is a much-discussed speech by the German President, Roman Herzog, delivered in April 1997, in which he criticised the ossification of German society and called for internal renewal.

remain internationally competitive. That a similar urgency for action was not visible at the political level (at least by the mid-1990s) added to a sense of frustration among the business community and a feeling that politicians were out of touch with reality<sup>73</sup>.

Finally it should, however, be said that while the gloomy scenario painted in the analysis above was characteristic for the period up to the mid-1990s, the economic and political outlook became a bit more optimistic in the following years as an upswing in the business cycle and export-led growth (helped by a strong US dollar) led to growth rates between 2 and 3 per cent and a reduction in unemployment. In fact, by the end of the decade unemployment had been reduced to just slightly over 10 per cent. Moreover, during the second half of the 1990s, the outgoing government of Helmut Kohl and the new left of centre government of Gerhard Schröder, which came into office in 1998, managed to pass a number of small business-friendly reform acts, such as for example a further liberalisation of Germany's shopping hours. Most significantly, in 2000 the Schröder government passed a reform act of Germany's tax system, which reduced corporate tax rates and made it easier for companies to sell cross-shareholdings.

### **Implications for an Analysis of MNEs' Political Influence**

Chapter 1 has pointed out that institutions can be sources of political influence by structuring interactions between actors in certain ways. Indeed, a review of the institutional structure of Germany's economic policy-making process has shown that private actors, and particularly the business community, enjoy prominent positions in economic policy-making networks. However, while one can find evidence that these institutional arrangements continued to function in the 1990s, one can also cite evidence that points to the opposite direction. In fact, there appears to be no consensus in the literature as to whether current developments indicate the beginning of a hollowing out of Germany's institutions or simply a re-adjustment to new economic realities. As a result of this ambiguity, sweeping statements about the importance of institutions for the political influence of German MNEs are hardly convincing. In fact, as noted earlier, this study will remain agnostic regarding the general and long-term

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<sup>72</sup> Interviews

<sup>73</sup> Interviews. See also Streeck (1997) and "Germany's new shop window" *Financial Times*, Nov. 20 1998 and "Restructuring corporate Germany" *The Economist*, Dec. 5 1998.

implications of these developments and will instead analyse in the following chapters on a case by case basis whether institutions were a source of political influence for MNEs or not.

Having said that, it seems nevertheless clear that political and economic circumstances are likely to be of importance. First, it was pointed out that over the last decades state activities increased substantially. Public sector share of GDP increased from 30 to 40 per cent in the 1960s to roughly 50 per cent during most of the 1990s. It was noted that the principal motivation behind the increasing activities of the state appears to have been a desire to engineer “just” market outcomes. Hence it seems likely that MNEs’ political influence will be conditioned by the extent to which their preferences are compatible with those of the state.

Second, it was argued that Germany’s failure to decisively reform a number of economic policies and practices can, at least partly, be linked to the activities of organised interests more concerned with the preservation of the status quo than with adjusting to a changing international division of labour. In fact, interviewees frequently complained about an increasing “politicisation” of economic policy-making, which was preventing much needed economic reforms and hence slowed down the pace of structural adjustment<sup>74</sup>. In other words, the degree of domestic opposition is also likely to condition MNEs’ political influence.

Finally, it was pointed out that collective wage bargaining agreements – a cornerstone of the German *social partnership* model – became less comprehensive during the last decade and that a number of observers have linked this phenomenon to a relative decline of the political power of unions vis-à-vis employers as a result of globalisation. In other words, increasing levels of internationalisation can in certain policy areas constitute sources of political leverage.

In short, an analysis of Germany’s economic policy-making process has shown that institutions must certainly be part of any explanation of the political influence of German firms. It was pointed out that German firms were through a number of institutions tightly linked to the policy-making process, and that it was plausible to assume that these linkages enabled firms to wield considerable political influence. However, it was also noted that one should not take this argument too far. First, in recent years a number of authors have diagnosed cracks in Germany’s institutions that might make their importance less pervasive. Second, a macro-level review of political and economic circumstances suggested that it was entirely plausible to assume that these developments can have an impact on the preferences of

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<sup>74</sup> Interviews.

the government, the extent of domestic opposition and the degree to which firms can use their internationalisation process for political leverage, and should thus be part of an analysis that seeks to explain MNEs' political influence.

## Switzerland

### **Institutional Structure of the Economic Policy-Making Process**

In many ways the institutional structure of Switzerland's economic policy-making process is similar to the German one – at least on a superficial level. Again, it is policy-making by consensus through continuous, institutionalised bargaining processes between the main domestic groups. And again, firms participate legitimately in the policy-making process through their sectoral and peak associations. Max Frisch, referring to the close links between business and government in Switzerland coined the term *Schweiz AG* (Switzerland Inc.). However, this is where the similarities end and important differences begin to emerge. These differences concern the process by which policies are normally devised and the political culture that lies behind much of Swiss economic policy making. Both aspects are relevant for an analysis of MNEs' political influence.

In many ways, the Swiss policy making process is a showcase of decentralisation. Even when compared to a highly decentralised country like Germany, Swiss levels are quite extraordinary. In fact, as Meir and Marthinsen have argued, all political institutions and procedures are geared towards the diffusion of political power. This is particularly visible in the federal structure, which gives the *cantons* considerably more powers than the German *Länder* (e.g. cantons have the right to set tax rates and were until recently also in charge of health care policies)<sup>75</sup>. Other prominent institutions that reflect the diffusion of political power are the “magic formula” under which the four largest political parties have been governing Switzerland for more than three decades<sup>76</sup> and the referendum, the symbol of

<sup>75</sup> Meir and Marthinsen (1996), p. 5.

<sup>76</sup> The federal council (*Bundesrat*) is the executive arm of the government and is composed of seven members. For over 35 years, the composition of the FC has been shared by the four major political parties with the unwritten rule that the Social Democrats, the Liberals and the Christian Democrats each get each two seats and the Swiss People's Party gets one.

Switzerland's direct democracy, which stipulates that any law passed by parliament has to be submitted to a nation-wide vote if at least 50,000 voters or eight cantons request it<sup>77</sup>.

The possibility to relatively easily exercise political influence has not only led to the development of a thick net of organised interests<sup>78</sup>, but also to a particular decision-making process. In order to avoid referendums, draft pieces of new legislation go through two pre-parliamentary stages (*Expertenkommission and Vernehmlassungsverfahren*) which include all affected groups and whose task it is to come up with a compromise solution acceptable to all. Only then are policy drafts sent to parliament for deliberation. Borner et al. have argued that the actual parliamentary stage of the policy making process is of relatively little importance compared to the pre-parliamentary stages. Although bills have to be debated and passed by both houses of Parliament – the National Council and the Council of States – the scope for changes is minimal, since drafts already represent carefully negotiated compromises and any changes would risk a referendum. So although the Swiss executive (*Bundesrat*) is nominally very powerful - simplified it is president, prime minister and cabinet in one institution - this power is not reflected in a strong and active leading role. Rather than making policy, the *Bundesrat's* main task has traditionally been to sanction agreements by the main domestic groups<sup>79</sup>. As has been pointed out many times, this policy-making structure is well suited to bring about incremental policy change and has thus often been credited as the main source of Switzerland's famous political stability<sup>80</sup>.

Similar to Germany, the decentralisation in the public sector contrasts strongly with the centralisation of the private sector. Swiss firms are organised into sector associations under the umbrella of their main peak association, the *Schweizerischer Handels und Industrieverein*, better known as the *Vorort*. In the labour domain the *Trade Union Federation*, the *Christian National Trade Union* and the *Union of Swiss Employees* provide a united labour front for negotiations and discussions with the government. Wage and salary negotiations are handled at the industry or company level in Switzerland.

The decentralisation of the public sphere and the centralisation of the private sphere link up in one institutional structure, mainly through the institutions of Switzerland's direct democracy, which require close co-operation between the public and the private sector for the

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<sup>77</sup> If at least 100,000 voters sign an initiative (or at least one of the two houses of the Federal Assembly votes affirmatively) a nationwide vote is held to change the constitution or federal laws.

<sup>78</sup> For an overview of organised interests in Switzerland see Knöpfel (1988).

<sup>79</sup> See Borner et al. (1990), p. 68.

<sup>80</sup> See for example Katzenstein (1984).

formulation of policies<sup>81</sup>. Nevertheless it has often been argued that firms and their associations enjoy disproportionate influence<sup>82</sup>. In fact, a number of authors have argued that the political power of Swiss business is unparalleled in Europe<sup>83</sup>. The sources of firms' political power are plentiful. First, the trade associations are not mere lobby groups, which try to advance the interests of their members. Even more so than in Germany, they fulfil an essential function by providing the only modestly staffed *cantonal* and federal governments with important technical information and, again even more so than in Germany, there is a strong tendency on part of the state to transfer public duties to private actors<sup>84</sup>. In fact, Germann has argued that the refusal of the associations to implement policies is just as effective as the threat of a referendum<sup>85</sup>. Second, Borner et al. have pointed out that the political influence of the trade associations is further bolstered by the relative weakness of Switzerland's political parties, which are relatively small, not well organised and poorly funded. According to them, "political parties' main function is the recruiting of politicians and the organisation of political campaigns. On concrete political decisions, they have little influence"<sup>86</sup>. In contrast, the trade associations are better funded and command more technical expertise on questions of economic policy-making<sup>87</sup>. Moreover, Switzerland's instruments of direct democracy guarantee the trade associations direct influence over policy outcomes and enable them to act as "quasi parties"<sup>88</sup>.

Apart from these features, there is, however, another element in the Swiss economic policy-making process which further buttresses firms' political influence and which contrasts sharply with Germany's economic policy-making process. While German economic policies are shaped by liberal ideology – albeit to a declining extent - a number of Switzerland's economic practices are notable for the absence of any such influence. As a result, this has opened the door for some firm lobbying and influence that would be quite unimaginable in Germany. To be sure, with regard to foreign economic policy, Switzerland has always followed a liberal policy. Being a small and resource poor state, Switzerland has had little choice but to support a multilateral free trade regime and it was probably this external side of trade policy, which has seduced many analysts to describe Switzerland's economic policy

<sup>81</sup> See for example "Anpacken statt Jammern" Rudolf Walser, Secretary at the Vorort, *Frankfurter Allgemeine Zeitung*, March 25 1997

<sup>82</sup> See Katzenstein (1984) and Sally (1993).

<sup>83</sup> See for example Borner et.al. (1990), p. 74 and Neidhart (1988), p. 110.

<sup>84</sup> See Borner et.al. (1990), p. 71, Sommaruga (1987) and Borner and Porter et al. (1991),p. 287.

<sup>85</sup> Germann (1981).

<sup>86</sup> Borner et al. (1990), p. 74.

<sup>87</sup> See Winterberger (1980).

<sup>88</sup> See Borner et al. (1990), p. 74.

making system as liberal<sup>89</sup>. However, when one extends the term “open” to Switzerland’s domestic market and to the extent to which price competition allocates resources, doubts quickly emerge regarding the viability of the above judgement.

Although Switzerland’s free market economy is guaranteed through its constitution, market freedoms are rather poorly safeguarded. Petersmann has argued that the Swiss anti-trust Commission – a group of representatives from the business community, academia and consumer groups – was never equipped with the necessary personnel and administrative resources to be an effective guardian of a free market order. Furthermore, Swiss competition law is largely toothless and shaped by a corporatist tradition and a cartel-friendly attitude. In fact, the cartel article in the constitution merely legitimises an *ex post* abuse control, but not, as in other countries, preventive rules or laws<sup>90</sup>. Moreover, the anti-trust commission may only interfere in extreme cases of abuse in which overall economic damage can be proven. As long as cartels merely distort competition they are not seen as damaging<sup>91</sup>. The result has been a widespread cartelisation of the Swiss economy with the trade associations “administering” competition in a number of sectors. Prominent examples include the insurance and banking sector during the 1980s, agriculture, car body shops and the construction sector<sup>92</sup>.

Borner et al. have argued that Switzerland’s unparalleled tolerance for cartels is a reflection of Switzerland’s political culture. Being an extremely heterogeneous country – hardly any other nation displays so many different cultural characteristics in such a small geographical area (i.e. 4 languages) – Switzerland needed special institutional mechanisms to solve conflicts in order to ensure long-term stability<sup>93</sup>. The previous section has pointed out that virtually all decision-making processes involve extensive consultations, bargaining and compromises. Borner et al. have argued that the same pattern emerges in competition policy. According to them, there is widespread mistrust and fear to leave economic processes to uncontrolled competition where the results are not known and cannot be foreseen. Instead the acceptance of administered competition is very high. As they put it, “free rivalry between companies is rejected in the same manner as free rivalry between political parties for political power”<sup>94</sup>.

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<sup>89</sup> See for example Katzenstein (1984).

<sup>90</sup> Petersmann (1992), p. 298.

<sup>91</sup> See Borner et al. (1990), p. 130.

<sup>92</sup> See Petersmann (1992), p. 299.

<sup>93</sup> Borner et al. (1990), p.129.

<sup>94</sup> *Ibid.*

Having outlined the main structural features of the Swiss economic policy-making process, the analysis can now turn to recent economic and political developments in order to provide the context in which policy-making took place during the last decade.

### **Economic and Political Circumstances**

Similar to Germany, Switzerland's inclusive economic-policy making process has often been praised for facilitating structural change while at the same time preserving social stability<sup>95</sup>. Indeed, for most of the second part of the twentieth century, this seems to have been the case. Per capita income and net wages have been among the world's highest<sup>96</sup> and despite its small size, Switzerland is a significant trading nation - in 1992 Switzerland was the world's 14<sup>th</sup> largest exporter<sup>97</sup>. Moreover, these achievements have been accompanied by harmonious labour-industry relations<sup>98</sup>, low inflation and unemployment had for a long time been virtually non-existent. However, again similar to Germany, economic developments during the 1990s – a stagnating economy and rising unemployment (see below) – cast a shadow of doubt upon the view that what was happening in Switzerland over the last decades was “controlled adjustment”. Instead it seems to have become plausible to argue that when confronted with structural change, Switzerland's highly consensus-oriented policy-making arrangements led to political gridlock and gave way to increasing state intervention. Ultimately both developments lowered, with the usual time lag, Switzerland's capacity to adjust to a changing international division of labour.

Petersmann has pointed out that over the last decades a number of articles were added to the Swiss Constitution which transferred considerable confidence to the state for fine-tuning economic processes and defining general economic interests<sup>99</sup>. Schwarz has pointed to fiscal

<sup>95</sup> See for example Katzenstein (1984).

<sup>96</sup> See Meier and Marthinsen (1996), p. 15 and Enright and Weder (1995), p. 1.

<sup>97</sup> See Enright and Weder (1995), p. 5.

<sup>98</sup> In the period from 1970 to 1988, the Swiss economy lost only 1.4 days per 1000 employees due to strikes. For Germany this figure was 43. In comparison, the UK, Spain and Italy lost more than 450 days. See Borner et.al. (1990), p. 50.

<sup>99</sup> Petersmann (1992). An example is the federal trade policy law of 1982, which allows the *Bundesrat* – as longs as circumstances require it – to control, restrict or prohibit the import or export of goods and services. This has, in fact, put constitutionally guaranteed free trade under the discretionary power of the government of the day. See Petersmann (1992), p. 300.

policies aimed at engineering outcomes<sup>100</sup> and *Vorort* President Andres Leuenberger has observed, that

“the government has become more assertive and self-confident and does not shy away from handing out benefits which it must know should be rejected from an *Ordnungspolitik* point of view”<sup>101</sup>.

Moreover, Schwarz has argued that Switzerland’s market order has been increasingly distorted by a drastic expansion in the scope of welfare services, a lack of decisive privatisation and deregulation measures and proliferating regulations, which reduced transparency<sup>102</sup>.

Indeed, a look at the numbers points to a clear pattern: a steady, but continuous increase of the state’s involvement in the economy. While state spending is still below most European nations, it has increased during the 1990s to levels that are above the US and Japan and much closer to the OECD average. In 1994, federal government expenditures accounted for 37 per cent of GDP, up from 25 per cent in 1975 (see figure 4.2)<sup>103</sup>. Increases in welfare spending and subsidies were also significant: since 1960 the share of social welfare spending of GDP increased from 9 to 21 per cent and by 1993 over half of the federal governments’ revenues were distributed as subsidies<sup>104</sup>. These developments had highly negative implications for fiscal policy, one of the traditional cornerstones of Switzerland’s stability. While the budget showed a surplus during most of the 1980s, there was a significant turn-around in the 1990s. In 1993, the budget deficit was approaching 5 per cent of GDP despite a rise in petrol taxes in that year. Reflecting on these developments, Leuenberger has argued that the Swiss State had become no longer a guarantor of order, but rather a distributor of welfare services and other benefits<sup>105</sup>.

Compared to Germany, however, this development is less advanced in Switzerland. While the Swiss State has certainly become more active in recent years, federal government spending has clearly not reached levels that were common in Germany during the last two

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<sup>100</sup> Schwarz (1990, 1997).

<sup>101</sup> See Leuenberger (1995).

<sup>102</sup> Schwarz (1990, 1997). Meir and Marthinsen have noted that by 1995 government ownership was still large relative to other OECD nations. See Meier and Marthinsen (1996), p. 25.

<sup>103</sup> These figures include, however, only spending by the federal government. If one includes cantons the figure for 1994 is 45 per cent. See “Anpacken statt Jammern” Rudolf Walser, Secretary at the Vorort, in *Frankfurter Allgemeine Zeitung*, March 25 1997.

<sup>104</sup> See Meir and Marthinsen (1996), p. 5.

<sup>105</sup> Leuenberger (1995).

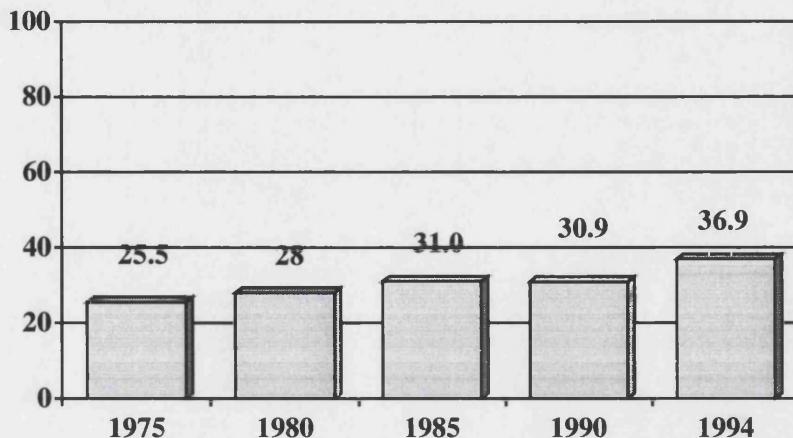


Figure 4.2: Federal Government Expenditure as a Percentage of GDP.

Source: World Economic Freedom Report 1997, p. 178.

decades. Moreover, while regulations have certainly been proliferating in recent years, the Swiss economy is still considerably less regulated than the German economy. The 1997 Economic Freedom Report ranked Switzerland as the 6<sup>th</sup> freest economy in the world. Rating one-tenth of a point higher than the United Kingdom, it is the highest ranked country among the European nations. Moreover, Switzerland has sustained this position over a lengthy time; it has been ranked between 2<sup>nd</sup> and 6<sup>th</sup> place throughout the last two decades<sup>106</sup>.

However, similar to Germany, Switzerland saw a significant deterioration in its economic performance during the last decades and particularly during the 1990s. In the period from 1973 to 1990, Swiss GDP grew by a meagre 1 per cent annually and economic activities in 1996 were only marginally above those in 1990 – in other words, there was zero growth during most of the 1990s (see table 4.2)<sup>107</sup>. Unemployment also increased. For years the Swiss unemployment rate was below 1 per cent and the envy of most OECD countries. However, during the recessionary years of the early 1990s, unemployment increased to 2.5 per cent in 1992 and 4.7 per cent in 1994. By 1996, it stood at 5.1 per cent (see table 4.2). Meier and Marthinsen have noted that the rise in unemployment was significant as it grew at a faster rate than real GDP fell, indicating that structural and not only cyclical forces were at

<sup>106</sup> See Gwartney and Lawson (1997), p. 179.

<sup>107</sup> *Vorort* Annual Report (1995), p. 29.

work. In fact, it has been estimated that Switzerland's structural (natural) rate of unemployment increased during the early 90s from 1 to 3.5 per cent<sup>108</sup>.

	1960-1973	1973-1980	1980-1989	1990-1997
Change in real GDP	3.7	1	1	0.5
Unemployment	0.1	0.3	0.5	3.9

Table 4.2: Economic Growth and Unemployment Rate in the period from 1960-1997.

Source: Bundesamt für Statistik, Quarterly Reports.

However, it must be said that while Switzerland's economic performance as a whole has been rather dismal during the first half of the 1990s, the internationally-oriented sector of the economy has done remarkably well – in the period from 1990 to 1995 value-added per employee in the manufacturing sector occupied the first place in an international comparison, ahead of the US and UK and significantly ahead of Germany and France<sup>109</sup>. This should, however, not be interpreted as a positive indicator for the quality of the Swiss production location. The vast majority of firms in this sector are highly internationalised (like for example Nestle, ABB or the three selected pharmaceutical MNEs) and a number of authors have argued that the reasons behind their success were more company-specific than Swiss-specific<sup>110</sup>.

In fact, since the late 1980s, a number of studies have been warning about Switzerland's declining competitiveness, or more precisely, its capacity to attract internationally mobile capital<sup>111</sup>. Since 1990 capital outflows have significantly exceeded capital inflows. While it is certainly tempting to argue that as a small nation, Switzerland was somehow hit harder by a changing international division of labour than Germany, Borner and Porter have argued that even in the case of a small, internationally-oriented economy like Switzerland, such problems

<sup>108</sup> See Meir and Marthinsen (1996), p. 19. See also IMF (1994), p. 127.

<sup>109</sup> See Koellreuter (1997).

<sup>110</sup> See for example Borner et.al. (1990), p. 44.

<sup>111</sup> See for example Kneschaurek (1989).

were usually home-made<sup>112</sup>. Indeed, one can point to a number of domestic problems, which make the Swiss production location increasingly problematic for firms.

Overall levels of regulation have been increasing, protection of agriculture production has proven costly (Switzerland's farmers enjoy the world's most generous subsidies) and the governments' reluctance to privatise monopolies on infrastructure services, such as telecommunications, have delayed the modernisation of these services. In its 1996 Annual Report, the *Vorort* explicitly warned about high domestic costs, taxes, social costs and proliferating regulations<sup>113</sup>. Moreover, Koellreuter has argued that cartel-friendly Switzerland increasingly burdened companies both on the cost side – since production inputs purchased from domestic suppliers were too expensive – and on the selling side due to a lack of innovation pressure<sup>114</sup>.

Differences in laws and regulations between cantons have been another important issue. While competition between different systems of organisation is certainly healthy, a line must be drawn where differences do not promote competition but rather impede it. In Switzerland, one finds a number of laws and regulations that do just that. Examples include the incompatibility of professional and high school certificates, state monopoly on certain types of insurance services and government and *cantonal* procurement policies, which openly prefer local suppliers and manufacturers. Moreover, a large number of civil servants and foreign workers cannot move freely between cantons without losing their *cantonal* employment insurance<sup>115</sup>. All these factors have become a burden to the internationally-oriented sector of the economy.

Much is often made of the question whether Switzerland's strategy of remaining outside the European Union is an economically viable one in an age of rapid economic integration. It seems, however, that the answer to this question depends on the perception one has about the nature of the EU. If one sees the EU as essentially a trade facilitating and competition promoting organisation of states, which have recognised that in an age of globalisation, the way forward is not to jealously guard national sovereignty but rather to pool it in order to speed up decision-making and free it from often parochial influences, then certainly it would be to Switzerland's advantage to join. If, however, one sees the EU as a competition distorting organisation, driven by bureaucrats and politicians keen on harmonisation as a

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<sup>112</sup> See Borner and Porter et al. (1991).

<sup>113</sup> See *Vorort* Annual Report (1996), p. 29.

<sup>114</sup> See Koellreuter (1997).

<sup>115</sup> Senti and Baltensperger (1991, pp. 44, 147) have estimated that at least 300,000 civil servants have their freedom of movement restricted by the incompatibility of cantonal employment insurance schemes.

means to cartelise the European economy in order to shield it from the pressures of global capitalism and to avoid socially disruptive structural adjustment measures (such as the deregulation of rigid labour markets), then Switzerland would certainly be better off staying outside the EU. It shall not be the task of this study to sort out this debate. However, it seems that a case can be made for both views. Having said that, it seems nevertheless clear that the no-vote in the December 1992 referendum on participation in the European Economic Area (EEA) was an opportunity missed. Borner and Porter have pointed out that joining the EEA would have allowed Switzerland to eliminate potential discrimination by the EU without having to join the Union with all its, to some extent questionable policies, i.e. the common agricultural policy<sup>116</sup>. Moreover, it would have presented Switzerland with an opportunity to adopt in one stroke some much needed reforms - without having to go through the usual painstaking and cumbersome decision-making process - as participation would have required the Swiss government to reform immigration policy, implement a more rigid anti-cartel policy and make public procurement policies more competitive<sup>117</sup>.

In short, an analysis of recent economic developments showed that state activities markedly increased as a structurally changing world economy began to threaten domestic employment and income distribution. Instead of responding to a structurally changing world economy with liberalisation and deregulation policies in order to facilitate adjustment, successive Swiss governments were more interested in trying to engineer market outcomes that were deemed socially desirable<sup>118</sup>. As the *Vorort* has argued,

"Over the last decades, successive Swiss governments were more interested in creating a large and extensive tool kit of economic instruments rather than establishing the necessary framework conditions for a free economic order"<sup>119</sup>.

Increasing state intervention has, however, not been the only defining characteristic of economic policy-making in Switzerland. Similar to Germany, Switzerland's once quiet and stable policy-making process became increasingly confrontational and politicised as well-organised interest groups proliferated during the second half of the 1980s and the first half of the 1990s. In fact, Switzerland appears to have been no exception to Mancur Olson's claim that stable societies will over time produce a large number of distributional coalitions aligned

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<sup>116</sup> See Borner and Porter (1995), Chapter 10.

<sup>117</sup> See Enright and Weder (1995), pp. 7f.

<sup>118</sup> See Schwarz (1990, 1997).

against change<sup>120</sup>. The *Vorort* has observed many times, that Switzerland has produced powerful vested interests which are strongly opposed to change<sup>121</sup>. Indeed, a number of authors have argued that Switzerland's traditional advantages – low inflation, fiscal prudence, political stability and social peace - could now be found in a lot of other countries, while at the same time Switzerland failed to implement deregulation and competition promoting measures<sup>122</sup>. Instead, policies intended to cushion the effects of international competition frequently prevailed under the pressure of an emotionally charged public opinion<sup>123</sup>. One indicator for the increasing politicisation of Swiss policy-making has been the increasing number of referendums. Kleinewefers has pointed out that there has not only been a strong increase during the last decade, but that the list of policy issues brought to a referendum has also become much longer.<sup>124</sup>. From animal testing to biotechnology regulations, the range of issues has been increasing steadily. At the same time, anti-market sentiments have increasingly featured among a growing number of interest groups (e.g. environmental groups), which appeared to be driven by a general scepticism of market processes and technological progress<sup>125</sup>.

Similar to Germany, the issue of how to adjust to globalisation has proven to be particularly divisive and led to confrontational discussions between the business community, government and a host of interest groups. While the internationally-oriented sector of the economy strongly advocated deregulation and liberalisation measures in order to facilitate the adjustment to a structurally changing world economy, the government and the vast majority of interest groups were, however, more sceptical and blocked a number of important reform initiatives through referendums. Examples included the 1991 referendum to replace Switzerland's turnover tax with value-added tax<sup>126</sup> and the 1992 referendum on Switzerland's participation in the EEA. Similar as in Germany, this conflict was re-inforced by restructuring measures in Switzerland's export-oriented companies, which contributed to a sense among the business community that while companies were trying to meet the new

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<sup>119</sup> *Vorort* Annual Report (1993), p.43.

<sup>120</sup> See Olson (1982).

<sup>121</sup> See for example *Vorort* Annual Report (1992), p. 29.

<sup>122</sup> See for example Borner et.al. (1990), Borner (1996), Moser (1996) and *Vorort* Annual Report (1994), p. 21.

<sup>123</sup> See for example *Vorort* Annual Report (1994), p. 25.

<sup>124</sup> Kleinewefers (1997).

<sup>125</sup> Ibid.

<sup>126</sup> The turn-over tax has been particularly business unfriendly since it put a disproportionate burden on investments and intermediate goods. See Meier and Marthinsen (1996), p. 25.

challenges head-on, the government was somehow out of touch with reality<sup>127</sup>. As a result, traditionally close government-industry relationships became less stable during the last decade as the business community became increasingly impatient with the government's inability to deliver economic reforms. In the words of one official at the *Vorort*,

"Switzerland has not understood globalisation as a challenge, but rather as a threat and confronted with the need for structural change, it has responded with denial"<sup>128</sup>.

Within this context, the institution of the referendum has become increasingly controversial. While the referendum has certainly served Switzerland well in the past by providing stability and cohesion, doubts have arisen during the 1990s as to whether this particular policy-making system was well-suited for a global economy in which competition was increasingly between whole production locations and which, as a result, rewarded flexibility and swift adjustment. A number of authors have argued that due to direct democracy, small parties and interest groups could weaken Switzerland's flexibility to adjust to outside changes by blocking policies which the vast majority of the voters did not reject<sup>129</sup>. Borner has argued that instead of a source of civic rights, the referendum seemed to have become an instrument of special interests to preserve the status quo and to secure rents at the expense of the economy as a whole. According to him, the *Schweiz AG* system of incremental change had reached its limits<sup>130</sup>.

During the second half of the 1990s, this bleak outlook became, however, somewhat brighter. In 1995, the government ratified a comprehensive economic reform programme that corresponded largely to the preferences of the business community (see below), and starting in 1997 the economy began growing again, helped by an upswing in the business cycle and export-led growth fuelled by a strong US dollar.

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<sup>127</sup> Interviews. See also "Die Globalisierung als Herausforderung", Peter Böckli in *Basler Zeitung*, March 22 1998.

<sup>128</sup> Interview.

<sup>129</sup> See Brunetti (1997), Borner and Porter et.al. (1991), Borner, Brunetti and Straubhaar (1990) and (1994), Brunetti and Straubhaar (1991) and (1996), Borner (1997), (1996) and Willemse (1992).

<sup>130</sup> Borner (1996), p. 7. See also Borner et al. (1990, p. 156). However, this view of direct democracy is not universally shared. Frey (1997, p. 183) has argued that the direct participation of the population in policy-making is an important pre-condition for a modern, future-oriented society which aspires to be politically and economically successful. In his view, direct democracy ensures that policies correspond to the preferences of voters and limits the power of politicians (ibid., p. 184). Indeed, a number of studies have praised Switzerland's direct democracy as an example to be followed. See Beedham (1993) and von Arnim (1993, 1995).

## Implications for an Analysis of the Swiss MNEs' Political Influence

During the 1990s it has become fashionable to argue that Switzerland's business community had lost its famous hold over economic policy-making<sup>131</sup>. Despite the *Vorort*'s often voiced preference for deregulation and liberalisation, the state became increasingly interventionist over the last decade. Particularly in the aftermath of the no-vote in the referendum to join the EEA, commentators concluded that the *Vorort* had lost much of its political influence and capacity to organise a coherent and successful political strategy<sup>132</sup>. Such arguments appear to be, however, exaggerated. While Swiss firms may no longer be able to rely on their accustomed insider role in closed policy-making processes, they remain nevertheless influential. In 1995, the government passed an economic reform package, which included a revised competition policy, liberalisation of public procurement policies and telecommunications services and the elimination of a number of technical barriers to trade – reforms which largely conformed to the *Vorort*'s preferences. Moreover, the reform abolished Switzerland's turn-over tax and replaced it by a value-added tax – a reform that failed in 1991<sup>133</sup>. Maybe even more important was the absence of a referendum on the ratification of the Uruguay Round and Switzerland's participation in the WTO. After the highly politicised debate about joining the EEA this was surprising and interesting at the same time. As Sherlock Holmes has observed, dogs that don't bark give important clues. One *Vorort* executive commented that the *Vorort* had during this time been rather explicit to the Farmer's Association about the negative consequences of a rejection for the Swiss export industry, which essentially foots the bill for agricultural subsidies and which had already been disadvantaged by the rejection of the EEA<sup>134</sup>.

Looking at these policy outcomes against the background of the evidence from the previous section, the implications for Swiss firms' political influence appear to be somewhat different than in the German case. It was argued that while the Swiss federal government had certainly become more assertive over the last decade, this development was less advanced than in Germany. State spending was less in Switzerland (at least at the federal level), the economy was still less regulated than in Germany and the system of direct democracy has still preserved to a degree, the states' traditional role of sanctioning agreements between the

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<sup>131</sup> See for example Ratti (1996).

<sup>132</sup> See for example Ratti (1996), p. 250.

<sup>133</sup> See *Vorort* (1997).

major domestic groups. As a result, it appears that political and economic circumstances are unlikely to be as important as in the German case for an explanation of policy outcomes. Instead, policies are likely to continue to be the kind of compromise solutions that Switzerland is famous for. In other words, institutions can be expected to remain an important explanatory factor. This observation fits in well with Schmitter and Grote's argument that Swiss corporatist structures have remained stable in the 1990s<sup>135</sup>.

That does, however, not mean that interests and political and economic circumstances are not important. In fact, with the proliferation of organised interest groups, Switzerland's economic policy-making institutions appear to have become a bit of a double-edged sword for Swiss firms. On the one hand, the institutional structure still guards against outright defeats, but on the other hand, as more groups became involved, compromises became more difficult to find and more interests had to be accommodated<sup>136</sup>. As a result, the degree of domestic opposition or the extent to which firms can use their internationalisation process for political leverage, can well be expected to make compromise policies more or less advantageous for firms. In other words, despite functioning institutions, interests and circumstances may still prove to be important explanatory factors.

## Conclusion

Chapter 1 has argued that interests and institutions were important sources of political influence for MNEs. However, it was also argued that in order to account for variations in MNEs' political influence across policy issues, these approaches had to be supplemented with an analysis of the economic and political circumstances in which policy-making took place. It was argued that circumstances affect institutions and perceptions of self-interest and thereby help to shape the preferences of the state, the degree of opposition from other organised interests and the extent to which MNEs' could use their internationalisation process for political leverage. Hence an analysis of MNEs' political influence had to incorporate circumstances as an explanatory factor. The purpose of this chapter was to provide the foundations for such an analysis. To this end, it has mapped out the institutional structures of

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<sup>134</sup> Interview.

<sup>135</sup> Schmitter and Grote (1997).

<sup>136</sup> See Josef Ackermann "Eine Fitnesskur für die Schweiz", *Neue Zürcher Zeitung*, Dec. 4/5 1993.

the German and Swiss economic policy-making process and provided a general overview of the economic and political circumstances in which policy-making was taking place during the period from 1985 to 1995.

The analysis has shown significant similarities and differences between Germany and Switzerland. First, while MNEs in both countries are part of an institutional structure that links them through their trade associations to the economic policy-making process, institutional linkages in Switzerland are tighter, mainly due to the institutions of direct democracy and the relative weakness of political parties and the state. Moreover, while at least according to some authors, institutions in Germany are beginning to show cracks, this phenomenon was less developed in Switzerland. Hence it was suggested that institutions were likely to be of greater importance for an explanation of the Swiss MNEs' political influence than for the German MNEs'.

Second, despite the importance of institutions for structuring German and Swiss policy-making processes, the preferences of federal governments appear to have become more important in both countries. It was shown that while neither state embraced heavy-handed government intervention, governments in both countries nevertheless intervened where increasing openness and market processes clashed with their desire for "fair" and "just" economic outcomes. In other words, while it may be fashionable in the 1990s to argue that markets have become all powerful and states have been condemned to eternal retreat, the last two sections have clearly shown that the case was not so unambiguous. In fact, in both Germany and Switzerland, state spending has increased significantly during the last decades and regulations have proliferated. This observation seems to support the argument of Chapter 1 that MNEs' political influence is likely to be conditioned by the degree to which their preferences are congruent with those of the state. It was, however, noted that this development was considerably more advanced in Germany. While the Swiss state has certainly also become more active over the last decade, it is still significantly less active than the German state. In other words, in an analysis of MNEs' political influence, state preferences might matter somewhat less in the Swiss case.

Finally, it was pointed out that while internationalisation may well have strengthened MNEs' political influence in certain policy areas (i.e. collective wage bargaining), there has also been a countervailing trend in both countries. In line with Olson's prediction that stable societies will over time produce distributional coalitions aligned against change, economic adjustment in both Germany and Switzerland has over the last decade been increasingly slowed down by vocal and well-organised interest groups. It was shown that in both countries

important economic reforms were opposed by organised interests, which seemed more keen on influencing the distribution of goods in their favour than on increasing the overall volume of output. Moreover, it appeared that the close identification of MNEs with the forces of globalisation exposed them substantially to the forces seeking to resist some of the consequences of that movement<sup>137</sup>. This study has deduced from these observations that the extent of opposition from other organised groups was likely to condition the political influence that MNEs were capable of exerting. However, clearly this opposition needs to be analysed within the context of MNEs' on-going internationalisation process, since the threat of shifting production abroad may well be effective to override interest group pressure in some policy areas.

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<sup>137</sup> Vernon has observed that the discussion of the costs and benefits of openness have become inseparable from discussions of the costs and benefits of MNEs. See Vernon (1998), p. 150.

# 5

## The Political Influence of the Six German and Swiss Pharmaceutical MNEs

The purpose of this chapter is to analyse the political influence of the six German and Swiss pharmaceutical MNEs with regard to the selected policy issues. The first step for such an analysis has been taken in Chapter 3, which has examined MNEs' policy preferences. Comparing these preferences now with actual policy outcomes will provide a yardstick by which the extent of MNEs' political influence can be analysed. However, such a comparison by itself is unlikely to *explain* MNEs' political influence. Chapter 1 has argued that it is hardly plausible to assume that MNEs' political influence is a neat function of their interests. Rather, political influence is also likely to be shaped by institutions and the economic and political circumstances under which policy-making took place.

Chapter 4 has pointed out that MNEs in both Germany and Switzerland are part of an institutional structure that has traditionally been regarded as a source of political influence for the business community. It was noted that in the German case the literature was not unanimous whether this was still true in the 1990s, while in the Swiss case it was argued that corporatist structures have largely remained intact. However, it was pointed out that in both countries it was also possible to identify developments relating to political and economic circumstances that might condition the extent to which MNEs could shape policies according to their preferences. In both states, governments became increasingly assertive over the last decades and policy-making processes became more politicised due to the activities of organised interest groups. Hence it was argued that MNEs' political influence was likely to be conditioned by the extent to which their preferences were compatible with those of the government and by the degree of opposition from other organised interests. Moreover, it was argued that the extent of MNEs' internationalisation process was, at least in some policy areas, likely to be a source of political leverage. The following sections will now analyse how all these explanatory factors came together to shape the political influence of the six MNEs with regard to the selected policy issues.

## The Three German MNEs: Hoechst, Bayer and BASF

Chapter 1 has pointed out that the policy issues of greatest significance for the three German MNEs were health care reforms, regulatory issues pertaining to biotechnology, intellectual property rights issues and parallel imports. However, not all of these issues will be covered in this chapter. In two of these four policy areas – intellectual property rights issues and biotechnology regulations - decision-making authority increasingly shifted to the EU level during the late 1980s and 1990s. Hence the political influence of the three MNEs with regard to those issues will be analysed in chapter 7.

While intellectual property rights were considered to be a completely “European” policy issue – in the sense that MNEs and their associations concentrated their interest representation efforts at the EU level<sup>1</sup> – the case with biotechnology regulations has not been so clear cut. Regarding the approval of production and research facilities, there was a division of labour between the European Commission and national governments: the Commission issued directives, on which basis national governments adopted regulations. However, EU directives leave member states considerable room for “interpretation” and, as a result, regulations vary significantly among EU member countries<sup>2</sup>. Hence regulatory issues pertaining to the approval of production and research facilities need to be analysed at both the national and the EU level as MNEs can be expected to try and influence both policy-making processes.

The second set of biotechnology regulations – regulations pertaining to the approval of drugs – increasingly shifted to the European level during the 1990s, a development that culminated in 1995 with the establishment of the *European Medicines Evaluation Agency (EMEA)*. The Boston Consulting Group has noted that with the possibility of obtaining Europe-wide approval and registration through the *EMEA*, national approval and registration procedures have largely lost their significance<sup>3</sup>. Hence regulations for the approval of drugs will be analysed in Chapter 7.

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<sup>1</sup> Interviews.

<sup>2</sup> Directives are addressed to the member states and must be transformed into national law; they are binding as to the result to be achieved, but the choice of method is left to the member states. See Art. 189 (3) of the Treaty of Rome. For variations in biotechnology regulations among EU member countries see Szczepanik (1993), Hohmeyer et al. (1994), Levidow and Carr (1996) and European Commission (1992 a, b).

<sup>3</sup> Boston Consulting Group (1995), p. 105.

## Health Care Policy Issues

Health care policies largely determine the prices that pharmaceutical MNEs can charge for their products. Hence it is not surprising that executives at Hoechst, Bayer and BASF referred to health care policy as one of the most important policy issues for their industry. During the late 1980s and early 1990s, Germany's health care system changed significantly as a result of two major reforms - the *Blüm Act* of 1989 and the *Seehofer Act* of 1993. The following section will now analyse the extent to which the three MNEs were able to shape these two policy outcomes.

Until the *Blüm Act*, the three German MNEs had very little to complain about since Germany's health care system provided them with relatively comfortable conditions. Producers were free to choose the price of their products and consumers were reimbursed by their health insurance, which usually covered pharmaceuticals with only minimal co-payments. Higher prices were simply passed on to consumers via higher insurance premiums<sup>4</sup>. Moreover, the three MNEs were well-positioned to influence the policy-making debate: through their trade associations – *the German Association of the Pharmaceutical Industry (BPI)* and, after 1994, *the Association of Research-Focused Pharmaceutical Producers (VFA)* – they are represented in the so-called "Concerted Action", a national forum that brings together the key decision makers of the health care system for the annual round of negotiations between health care providers and purchasers. Established in 1977, the Concerted Action meets twice annually and is convened by the Minister of Health. Over the years it has grown considerably and now has approximately 90 members from various organisations. Most prominent among them are the representatives of insurance funds and the associations of physicians, hospitals and industry. The Concerted Action has no regulatory powers but rather exerts its influence on the basis of "moral suasion". Regulation and supervision of the provision of health care is the responsibility of the *Länder*, while the financing of the system is largely a matter for federal authorities. Although this system was originally designed so that the government did not need to interfere into the process, but only sanctioned bargaining outcomes between the major actors, mounting financing problems in recent years propelled the government to intervene ever more frequently<sup>5</sup>.

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<sup>4</sup> Hoffmeyer and McCarthy (1993), para. 6.3.6.2.

<sup>5</sup> For a more detailed overview see Hoffmeyer and McCarthy (1993), para. 6.6.

A number of authors have linked these financing problems to highly distorted incentive structures<sup>6</sup>. Hoffmeyer and McCarthy have observed that the original intention of social solidarity has gradually been eroded.

“Today, there is a growing expectation that the costs of ever more services should be shared by society. Such expectations sometimes encourage abuse: instead of redistributing funds from the healthy to the sick, it is increasingly the healthy themselves who make use of entitlements, for reasons of availability, rather than for reasons of need”<sup>7</sup>.

In the words of one official from the *BPI*,

“the attempt to balance equity and efficiency resulted in incentives for doctors and hospitals to provide the most comprehensive treatments without any consideration for cost since constraints to offset the moral hazard problem resulting from health insurance programmes were largely absent. The result has been a strongly distorted incentive structure”<sup>8</sup>.

As long as the possibilities of medicine were limited, these incentive structures did not constitute a major problem. However, as rapid technological progress over the last decade dramatically increased the possibilities of medicine, costs began to explode<sup>9</sup>. In order to contain these costs, the government passed two major reform acts, the 1989 *Blüm Act* and the 1993 *Seehofer Act*.

In stark contrast to the competitive approach to health care described in Chapter 3, the *Blüm Act* was a clear case of distorting market processes in order to engineer outcomes. Instead of adding market-conforming constraints to foster cost-consciousness among all market participants (such as, for example, significant co-payments), the centrepiece of the act was a system of reference prices on which the reimbursement price was based. While the market price remained free, health insurance did not cover the difference between the market price and the reference price, which was decided – without industry participation – by the *Federal Association of Physicians* and *Sickness Funds*. Only significantly innovative drugs

<sup>6</sup> While in the 1960s most countries in Western Europe spent roughly 4 per cent of GDP on health care, this share had increased by the 1990s to between 8 and 11 per cent. In the United States it is 14.2 per cent. See Sommer (1997), p. 9.

<sup>7</sup> See Hoffmeyer and McCarthy (1993), para. 6.6.

<sup>8</sup> Interview.

were excluded from regulation based on this scheme<sup>10</sup>. The result was strong downward pressure on drug prices as firms were practically forced to lower their prices to the reference price. By 1991 average drug prices in the regulated market had fallen by 4.3 per cent compared to 1989<sup>11</sup>.

However, the reform was unsuccessful in bringing about sustained cost savings and was widely considered a failure. Savings were only substantial in the very early phase of the new system and tended to vanish quickly. In fact, between 1989 and 1992 pharmaceutical expenditures grew by about 30 per cent, approximately the same rate as before the reform. Hoffmeyer and McCarthy have argued that the reform was unsuccessful because firms (and doctors) responded to the distorted incentive structure with unanticipated compensating strategies so that the expected savings were largely offset. Since significantly innovative products were exempted from the reference price system, the definition of what constituted "true innovation" turned out to be rather difficult to establish<sup>12</sup>. An official at the Ministry of Economics remarked that firms were very skilled in interpreting to their advantage the endemic conflict between the regulatory logic, which tried to create the largest possible groups of products, and the medical logic, which insisted on biological and pharmacological differences. In fact, LePen has pointed out that while it was planned that references prices should apply to 80 per cent of the market, in the end only 30-40 per cent of available drugs were included. In addition, as the market was not fully covered by the system, large shifts in prescribing occurred towards the non-regulated sector where prices could be raised, resulting in an increase in total drug spending. The promotion policies of drug companies heavily supported this shift<sup>13</sup>.

The failure of the *Blüm Act* prompted the coalition government of Chancellor Kohl to look yet again at health care reform and the newly appointed Minister for Health, Horst Seehofer, was given the task of proposing new reform measures. After much debate, Seehofer was able to strike a consensus among the main political parties of the federal parliament, as well as with the *Länder* governments for a reform act, which came into effect in January 1993. From an *Ordnungspolitik* point of view, the *Seehofer Act* was even worse than the *Blüm Act*; the centrepiece of the reform was a budget for medicines prescribed by office-based doctors. In other words, the Act was based on the assumption that it was possible to estimate a fixed sum

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<sup>9</sup> See Sommer (1997).

<sup>10</sup> See LePen (1994), p. 51.

<sup>11</sup> Ibid., p.52.

<sup>12</sup> Ibid.

<sup>13</sup> See LePen (1994), p. 52.

for annual health care expenditure and then spread this sum across different services. Sommer has likened this shift from control of prices to volume as comparable to a shift to a command economy<sup>14</sup>. Moreover, the Act ruled that if the medicine budget was exceeded by up to DM 280m, physicians had to pay for the overrun in the following year by reducing their collective budget. If the budget was exceeded by more than that, the pharmaceutical industry would have to pay for the overrun. Finally, the Act decreed a price freeze for medicines not covered by the reference price system for 1993 and 1994<sup>15</sup>.

Unsurprisingly, the results of the *Seehofer Act* were far more significant than those of the *Blüm Act*. In fact, the threat to physicians' personal income had spectacular effects: in 1993 drug expenses by health insurance funds fell by DM 5bn as drug prescriptions by office-based physicians fell by more than 30 per cent. For the pharmaceutical industry the consequences of the *Seehofer Act* were drastic - depending on the company, sales were cut from 10 to 40 per cent<sup>16</sup>.

However, similar to the *Blüm Act*, the market distortions created by the *Seehofer Act* triggered distortions elsewhere in the system and the reform did not result in sustained savings. In 1995, two years after the introduction of the Act, the statutory health insurance was again recording deficits<sup>17</sup>. In the case of the *Seehofer Act*, the compensating strategies came from doctors, who preferred to send patients needing high levels of medication to hospitals – and thereby alleviate their budgets – rather than treating them themselves. In fact, already in the first quarter of 1993, German hospitals recorded a 6.7 per cent increase in the number of patients<sup>18</sup>.

Turning now to the three MNEs' political influence, both reforms were clearly far from MNEs' preference for policies aimed at embedding all market participants in a market order with incentives for cost-conscious and responsible behaviour. Instead reforms were dirigiste in nature, ignored incentive structures and were essentially short-term policies tackling the symptoms of the underlying problem. Rather than adding constraints designed to foster greater cost-consciousness among all market participants, the government opted for market non-conforming instruments such as mandatory price freezes, reference prices and expenditure ceilings for physicians. Unsurprisingly, the three MNEs were highly critical of the two policy outcomes. As one executive has put it,

<sup>14</sup> Sommer (1997), p. 2.

<sup>15</sup> For an overview of the Act see Hoffmeyer and McCarthy (1993), para. 6.3.

<sup>16</sup> See LePen (1994), p. 52.

<sup>17</sup> See BPI Annual Report (1996/97), p. 35.

<sup>18</sup> See report by the Association of German hospitals, quoted in *Frankfurter Allgemeine Zeitung*, June 12 1993.

“there are enormous dangers in administered pricing. It is very easy for governments to reduce drug costs on a short-term basis by administering the price of drugs. However, this creates tremendous market distortions. ...It also creates research dis-incentives because it severely diminishes the rewards for innovation”<sup>19</sup>.

Another executive added that

“both reforms were designed to cut expenditure in the short term and amounted to little more than treatment of the symptoms. Ultimately both reforms failed since they encouraged further distortions instead of generating greater efficiency”<sup>20</sup>.

The scale of the political defeat becomes even clearer when one looks at the share of drugs in overall health care costs and the contribution they have made to cost increases over the last decades. In 1994 drugs accounted for 12.5 per cent of overall health care costs, compared with 32 per cent for hospitals and 16 per cent for doctors. Moreover, the share of drugs had fallen in recent years – in 1991 it amounted to 15.3 per cent. In addition, drug prices rose since 1970 more slowly than the general price index, while hospital costs have doubled since 1960<sup>21</sup>. In other words, although the pharmaceutical industry contributed only insignificantly to the increase in health care expenditure, both reform acts focused cost saving measures disproportionately on the industry.

Indeed, the political defeat was so significant that the three MNEs no longer felt adequately represented by the *BPI* and set up their “own” sectoral association, the *Association of Research-Focused Pharmaceutical Producers (VFA)* which deals exclusively with the concerns of research-intensive pharmaceutical MNEs. As one executive has put it, “the BPI had simply become too heterogeneous and unwieldy as it also included generic drug and OTC producers whose interests were very different from ours [the research-focused pharmaceutical industry]”. Established in 1994 under the stewardship of a Bayer executive, the *VFA* became in the following years the main organisation through which the three MNEs articulated their policy preferences.

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<sup>19</sup> Interview.

<sup>20</sup> Interview. Analysing both health care reform acts, Boersch- Supan (1997) has argued that cost-containment measures in Germany have wholly ignored productivity increases as an important potential factor for cost savings. Moreover, he noted that the German health care system had a relatively low level of productivity, which was caused by distorted incentive structures and a lack of competitive pressures.

## Regulations Relating to Biotechnology Issues

Biotechnology regulations are frequently analysed in terms of their impact on a country's competitiveness<sup>22</sup>. Such concerns are, however, not the focus of this study. The goal here is to analyse the extent to which regulations conform to MNEs' preferences for a market-conforming regulatory regime. As has been pointed out earlier, this section will be concerned with regulations pertaining to production and research facilities. The equally important regulations pertaining to drug approval procedures will be analysed in Chapter 7 as they originate with the European Commission and the *EMEA*.

Formal German biotechnology regulation is a rather recent phenomenon. Until 1990, the application of this technology was regulated through informal guidelines from the Ministry of Science and Technology. However, during the late 1980s a number of developments rendered this state of affairs increasingly unsatisfactory. First, it has been documented that during the second half of the 1980s, the state bureaucracy became increasingly keen to extend its regulatory competence to this new technology<sup>23</sup>. In 1987, a joint *Bundestag* and *Bundesrat* working group concluded a review of the issue and recommended that legislation should be passed to formally regulate safety requirements for research centres and production facilities. Second, a further impetus for formal regulation came from the European Commission, which started during the late 1980s to prepare directives for biotechnology regulation (see Chapter 7). Since directives by the Commission have to be incorporated into national law, implementation of this directive would have required a formal regulatory regime. Third, by the late 1980s, the German population had become increasingly wary of biotechnology. Bandelow has pointed out that an increasing number of interest groups ranging from environmental and women's organisations, to consumer protection groups and the church, were successful in promoting scepticism and distrust among the population and exerted pressure on the government to regulate biotechnology<sup>24</sup>. In fact, it was estimated that around 40 per cent of the population had a negative attitude towards gene technology by the late 1980s<sup>25</sup>. Finally, the pharmaceutical industry was not entirely opposed to formal regulation. Although the informality of the existing regulatory regime corresponded largely to their preferences, operating conditions had become increasingly unpredictable. In 1990, for

<sup>21</sup> See Boston Consulting Group (1995), pp. 46-51.

<sup>22</sup> See for example Peterson (1989), Sharp (1989), Szczepanik (1993) and Wheale and Mc Nally (1993).

<sup>23</sup> See for example Bandelow (1999), p. 107.

<sup>24</sup> Ibid., p. 113.

<sup>25</sup> See Hennen and Stöckli (1992), p. 240.

example, a high court in Hesse ruled that existing guidelines were not a sufficient legal basis to permit Hoechst the construction of a production facility for human insulin. Although this verdict was widely criticised for being ill conceived and misleading, it strengthened the impression that legal certainty and predictability was not possible without a specific law<sup>26</sup>.

However, industry's support swiftly turned into opposition when the new law was passed in 1990. As it turned out, the new legislation was everything but market conforming and industry-friendly. First of all, the 1990 *Gene Technology Act* divided production and research facilities into four security categories, each with different application and approval procedures, and split approval responsibilities between the federal health care office (today the *Robert Koch Institute*) and the *Länder* authorities<sup>27</sup>. As a result some 30 agencies were dealing with the approval of gene technology-related work— something that made by itself a unitary interpretation unlikely and created uncertainties<sup>28</sup>. Second, while the 1990 *Gene Technology Act* was based on EU directives 90/219 and 90/220, the German interpretation differed in one crucial aspect from that of other European countries: in Germany, approval authorities were explicitly asked to consider larger societal concerns and interests in their decisions<sup>29</sup>. To this end, the act required mandatory public hearings preceding any decision. Several interviewees argued that this procedure led to tremendous delays and unpredictability for firms as organised interest groups jumped on this opportunity to voice their objections to biotechnology<sup>30</sup>. Indeed, the first public hearing attracted several thousands of objectors<sup>31</sup>. Moreover, the explicit reference to “larger societal interests” led to particularly strict interpretations of the law and further prolonged approval procedures<sup>32</sup>. Summarising the distinctive features of the 1990 *Gene Technology Act*, the Boston Consulting Group commented that German regulations distinguished themselves by excessive red tape, long waiting periods and uncertainty regarding the outcome<sup>33</sup>. In other words, the policy outcome clearly did not correspond to MNEs’ preference for a regulatory framework that was

<sup>26</sup> See Vitzhum and Geddert-Steinacher (1990), pp. 77-86. See also Dolata (1996), pp. 165-166 and Boston Consulting Group (1995), p. 113.

<sup>27</sup> In some cases, a federal commission for biotechnology safety (*Zentrale Kommission für die Biologische Sicherheit – ZKBS*) was also involved in the decision-making process.

<sup>28</sup> Bandelow has observed significant variations in the approval record of individual *Länder*. Particularly, Hesse has often been accused of intentional delays. See Bandelow (1999), pp. 123-125.

<sup>29</sup> See Bandelow (1999), p. 118.

<sup>30</sup> Interviews.

<sup>31</sup> See Winnacker (1993).

<sup>32</sup> Grund (1992) and Bauer (1993) have argued, that although approval procedures should not have taken longer than three months, they often took more than two years.

<sup>33</sup> Boston Consulting Group (1995), p.113. Bandelow (1999, p. 120) has noted that if, for example, a university wanted to conduct research involving gene technology of the first safety category, it had to fill out a 90-page

transparent, predictable, based on scientific principles and flexible enough to swiftly accommodate technological changes.

It should also be noted in this context that the results of the *Gene Technology Act* had been thoroughly negative for the German pharmaceutical industry. Klodt and Stehn, for example, argued that the act prevented German industry from developing the same capacity for innovation that it has in other technology areas<sup>34</sup>, and the Boston Consulting Group observed that Germany's global share of inventions in pharmaceuticals has dropped from 15 per cent in 1975 to 5 per cent in 1994<sup>35</sup>.

Unsurprisingly, the *Act* provoked strong opposition from the three MNEs. Under the umbrella of the *BPI*, the pharmaceutical industry started a nation wide advertising campaign to draw attention to Germany's relatively low competitiveness in this growth industry and the need for a reform of the *Gene Technology Act*<sup>36</sup>. The centrepiece of this campaign was the industry-sponsored *Initiative pro Gentechnik* (Initiative for Gene Technology), which placed regular advertisements in magazines and newspapers<sup>37</sup>.

The initiative led to results. Already in 1993 the *Gene Technology Act* was substantially revised and the regulatory framework became more market conforming. Approval procedures for the lowest-risk category were turned into mere application procedures; public hearings were restricted to only important cases and approval procedures were shortened to an average of three to seven months. These measures led to a significant improvement of the regulatory framework in terms of its transparency and predictability<sup>38</sup>.

However, the positive effects of this revision should not be overstated. While the revision certainly went some way towards making Germany's regulatory framework more market conforming, uncertainties have remained. These appear to be, however, less the result of regulations than the result of interest group pressure, which led to a very restrictive interpretation of the act<sup>39</sup>. Hoechst, for example, had to wait for more than eight years for the approval of a production facility for genetically produced human insulin, while during the same period rival companies in Denmark and the United States were producing this product

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application form, submit 15 copies and take blood samples of all involved personnel (including secretaries and cleaners), which then had to be stored for 20 years at minus 80 degrees.

<sup>34</sup> Klodt and Stehn (1994), pp. 61, 65.

<sup>35</sup> Boston Consulting Group (1995), p. 131.

<sup>36</sup> See Klodt and Stehn (1994), p. 57 and Boston Consulting Group (1995), pp. 64, 122.

<sup>37</sup> See for example *Der Spiegel*, No.50/1992 and *Frankfurter Rundschau*, Jan. 5 1993.

<sup>38</sup> See Klodt and Stehn (1994), p. 66.

<sup>39</sup> Quoting evidence from the renowned *Frauenhofer Institute*, Klodt and Stehn (1994, p. 67) have argued that the interpretation of the Act has had a far more restrictive influence than the Act itself. For a similar view see Bandelow (1997), p. 162.

and selling it in Germany. The comparison with Denmark is particularly significant since Danish regulations hardly differ from those in Germany<sup>40</sup>. Moreover, due to substantial interest group pressure it took two years (1993-1995) to find a solution for the loosening of gene technology safety requirements<sup>41</sup> and in 1995 interest group pressure delayed the introduction of genetically modified maize<sup>42</sup>.

## Parallel Imports

In recent years – and as a result of the single European market – parallel imports have emerged as one of the most important issues facing the German pharmaceutical industry. Chapter 3 has pointed out that these imports are the result of the single market that, on the one hand, encourages the free flow of drugs across countries but, on the other hand, leaves members states free to regulate their health care markets as they wish. As a result of these two policies, drug prices vary significantly across EU member countries and private dealers have discovered a lucrative trade reselling drugs bought in low-price regions to consumers in countries where prices are higher, such as for example Germany<sup>43</sup>.

Although parallel trade flows have been limited during the last decade - penetration rates in most European countries are low and even in the most affected market, the Netherlands, parallel imports have only reached around 10 per cent of sales – the industry has been arguing that the threat is nevertheless real<sup>44</sup>. According to the three MNEs, actual trade flows greatly underestimate the potential impact of parallel imports since for a manufacturer faced with the threat of parallel imports, the loss-minimising strategy is to reduce the price differentials in order to eliminate arbitrage opportunity. Thus the mere threat of parallel trade may suffice to make the lowest price within a trading area the effective maximum price<sup>45</sup>.

Moreover, several developments during the last decade significantly increased the potential threat of parallel imports. While parallel trade used to be constrained by a number of

<sup>40</sup> See Klodt and Stehn (1994), p. 66.

<sup>41</sup> See *Frankfurter Allgemeine Zeitung* Jan. 12 1995 and Jan. 18 1995.

<sup>42</sup> See *Die Zeit*, June 30 1995; *Frankfurter Allgemeine Zeitung*, June 8 1995 and June 21 1995.

<sup>43</sup> The existence of significant price differentials for patented medicines among countries within the EU is well established. Research conducted by NERA confirms that there is a marked variation between countries in prices of currently patented medicines. For example, at the end of 1994 prices in the Netherlands were over 75 per cent higher than those in Spain, and there was a range of prices between these extreme values. See NERA (1996), p. 5.

<sup>44</sup> See also NERA (1996), p. 8.

<sup>45</sup> Interviews. See also Danzon (1994), p. 10.

factors such as, for example, the need to obtain parallel import product licenses and to establish the co-operation with pharmacists and wholesalers, industry believes that there are strong grounds for believing that the institutional barriers to parallel trade are crumbling<sup>46</sup>. First, since 1995 new medicines that are approved by the European Medicines Evaluation Agency (EMEA) are automatically approved in all EU countries (see Chapter 7). It is widely held therefore that no parallel import product license will be required for such products<sup>47</sup>. Moreover, the resulting harmonisation of registration and labelling requirements is likely to reduce the costs of parallel importing and hence reduce the price differentials that can be sustained without inducing parallel trade<sup>48</sup>. Second, the potential impact of parallel trade has significantly increased with the accession to the EU of countries where prices are traditionally low, such as Spain and Portugal. An even bigger threat, however, is the possible accession of Eastern European countries.

Chapter 3 has argued that the three German MNEs were strongly opposed to parallel trade. They sustain that parallel trade is a means for importing the price regulations of other countries into Germany, and that trade under these circumstances is neither fair nor welfare-enhancing. While supporting the single European market, the interviewed executives argued that pharmaceuticals were a special case in which the single market did not yet function<sup>49</sup>. From their point of view, parallel trade should be restricted by policies that reinforced the segmentation of national health care markets.

Although the problem appears to be essentially a “European” one that one would expect to find in Chapter 7, the German pharmaceutical industry – at least until recently – concentrated its lobbying efforts on the German government, since the European institutions were generally unreceptive to the German industries’ complaints. The European Court of Justice, for example, has repeatedly upheld parallel trade as consistent with standard principles of free trade<sup>50</sup>. While acknowledging that price differentials for patented medicines largely resulted from the actions of governments, the ECJ found that such considerations were not relevant to the analysis and that the principle of free movement of drugs should take precedence over

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<sup>46</sup> See NERA (1996), p. 8.

<sup>47</sup> Ibid., pp. 8f.

<sup>48</sup> Previously, a 15-20 per cent price difference was necessary to cover the costs of complying with different regulations and other importing costs. See Danzon (1994), pp. 10f.

<sup>49</sup> Interviews. See also VFA Annual Report (1996), p. 8.

<sup>50</sup> When asked to rule on the rights accorded to a patent holder to prevent parallel trade, the Court has applied the principle of exhaustion of patent rights. If the owner of a patent right markets a patented product, or consents to it being marketed, in one member state, it has been argued that the patent right in another member state cannot be used to prevent parallel imports of the product concerned. See Danzon (1994), p. 7 and NERA (1996).

industry's fears that northern markets would be flooded by cheap medicines<sup>51</sup>. The European Commission has until recently taken a similar view and has been unreceptive to industry's arguments. In 1994, Bayer was fined by the European Commission for restricting supplies of Adalat to parallel exporters<sup>52</sup>.

As a result of this failure to win support from the Commission or the *ECJ*, the *BPI* and after 1994, the *VFA*, lobbied the German government to apply political pressure on the Southern European countries to reform their health care systems or to introduce measures for segmenting drug markets along national lines. However, as one association official has conceded, "despite many complaints, there have not been any tangible results"<sup>53</sup>. In fact, during the first half of the 1990s, the German government has not been much kinder to the pharmaceutical industry than the European Commission and the *ECJ*. Far from trying to prevent parallel imports from entering the German market, the government actually promoted them until recently through a clause in the health care act that forced pharmacists to sell parallel imports. Also, a 1993 decision by the German High Court suggested that pharmaceutical wholesalers would be forced to stock parallel imports, which in the past they have refused to do<sup>54</sup>.

However, during the second half of the 1990s, amid fears about declining competitiveness and falling research, firms' worries began to find a more sympathetic ear among the German government and the European Commission. In 1996, the German government dropped the clause in the health care act that forced pharmacists to sell parallel imports and the European Commission became also more receptive to industry's concerns. While there have not been any tangible results so far, the Commission at least set up a round table forum under the chairmanship of Martin Bangemann, commissioner for industrial policy, to study the issue and possible solutions. The *VFA* has interpreted this development as a step towards a more co-operative future and a more industry-friendly dialogue<sup>55</sup>. Similarly, the *ECJ* has become more co-operative. Although it did not fundamentally revise its previous decisions, it did concede that national price controls of some member states led to trade distortions in the single market<sup>56</sup>.

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<sup>51</sup> See Danzon (1994), p. 8. See also "Problem of parallels", *Financial Times*, March 16 1998

<sup>52</sup> See NERA (1996), pp. 8f.

<sup>53</sup> Interview.

<sup>54</sup> See NERA (1996), p. 9.

<sup>55</sup> See *VFA Annual Report* (1996), p. 17.

## The Political Influence of Hoechst, Bayer and BASF: An Analysis

An analysis of the three MNEs' political influence during the last decade has shown both outright defeats and qualified successes. Regarding health care policies, the three MNEs were strongly in favour of less state intervention and more competition-promoting measures and got precisely the opposite. With regard to biotechnology regulation, they supported a predictable and transparent legal framework and had to settle, at least initially, for one that was characterised by large unpredictability and uncertainty. Finally, with regard to parallel imports, they unsuccessfully lobbied for policies to reinforce market segmentation in Europe.

Lately, however, there were also some qualified political successes: the highly disadvantageous *Gene Technology Act* of 1990 was substantially revised in 1993, which resulted in a markedly improved regulatory environment. Moreover, the German government has recently taken more seriously industry's concerns regarding parallel imports. In 1996 it dropped a clause in the Health Care Act that forced pharmacists to sell parallel imports. On balance, however, the three pharmaceutical MNEs have been rather unsuccessful in shaping policy outcomes according to their preferences. The defeats have been substantial. How can one explain these policy outcomes?

Institutional explanations do not appear to be particularly helpful. Although the three MNEs were part of an institutional structure that provided them with strong linkages to the policy-making process, policy outcomes - with the exception of the 1993 revision of the *Gene Technology Act* - were highly disadvantageous for the three MNEs. Moreover, in the issue area where linkages to the policy-making process were strongest and most institutionalised – health care policy (see above) – the defeats have been particularly grave.

In fact, the evidence from the pharmaceutical sector appears to fit in well with the literature reviewed in the previous chapter that diagnosed cracks in Germany's institutions. However, the evidence was not entirely clear-cut. All three MNEs worked closely with their sector associations – until 1994 the *BPI* and after that the *VFA* – and relied on them for representing their interests in the policy-making process. In other words, the phenomenon of firms by-passing their associations was not visible in the pharmaceutical sector. Moreover, in contrast to other European countries, the German firms did not set up an association dealing exclusively with biotechnology issues – something, which has been interpreted as a sign of

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<sup>56</sup> Ibid.

faith in the existing organisational structure<sup>57</sup>. Apart from the *BPI* and *VFA*, the three MNEs have also occasionally relied on the *VCI* (*Verband der Chemischen Industrie*), which set up a working group for biotechnology staffed by executives from the three MNEs<sup>58</sup>. The *VCI* represents a broad spectrum of industrial interests and has been particularly important for high-level negotiations since it has been for decades one of the most influential trade associations in Germany<sup>59</sup>.

However, it must be said that while the three MNEs have refrained from individual lobbying and continue to rely on collective efforts to advance their political interests, the establishment of the *VFA* has been a significant sign. Set up under the stewardship of a Bayer executive, the *VFA* is neither a member of the *VCI* nor the *BDI* and operates outside of Germany's institutional structure. One interviewee has noted that the *VFA* looked more like a lobby group than an assistant to government<sup>60</sup>. In this sense the establishment of the *VFA* was not exactly an expression of faith in the traditional German institutional structure<sup>61</sup>.

Interests appear to be more helpful to make sense of the three MNEs' political influence. Essentially the three MNEs suffered three substantial political defeats – the two health care reforms and the 1990 *Gene Technology Act* – and scored one significant political success – the 1993 revision of the *Gene Technology Act*. What distinguished the success from the defeats was a highly visible, high profile public relations campaign that preceded the revision. In other words, rather than relying on traditional channels of interest representation, the industry went public with their complaints. In fact, Klodt and Stehn have explicitly argued that the pharmaceutical industry's public campaign was a decisive factor in bringing about the revision of the 1990 *Act*<sup>62</sup>. While there appears to be some truth to this argument, it is not entirely convincing since it inevitably leads one to conclude that the MNEs could have also been more successful with regard to health care policy if they had only mounted a similar high profile campaign. However, for reasons shown below, this appears to be highly unlikely.

Chapter 1 has argued that the explanatory power of institutional and rational choice explanations could be enhanced by supplementing them with an analysis of the impact of

<sup>57</sup> See Ronnit (1997), p. 84. In most European countries, the pharmaceutical industry set up associations exclusively for biotechnology-related issues: France – Organibio (1984), Belgium – BBA (1986), Italy – ASSOBIOTEC (1986), Great Britain – BIA (1989), Spain -Bioindustrias (1989), Netherlands – NIABA (1987).

<sup>58</sup> Ibid.

<sup>59</sup> See Teltschik (1992).

<sup>60</sup> Interview.

<sup>61</sup> Interview.

<sup>62</sup> See Klodt and Stehn (1994), p. 62.

changing economic and political circumstances on the preferences of the government, the degree of opposition that MNEs were facing from other domestic groups and the extent to which MNEs were able to use their internationalisation process for political leverage. Indeed, such an analysis goes a long way towards explaining variations in the three German pharmaceutical MNEs' political influence.

With regard to health care, the three factors combined in a highly disadvantageous way for Hoechst, Bayer and BASF: first, the government had a strong interest in the issue and this interest was not exactly compatible with that of the three MNEs. All interviewees agreed that the determination of the government to contain rising health care costs and achieve instant results was the driving force behind the reforms of 1989 and 1993, while the concerns of the pharmaceutical industry were only of secondary importance. According to them, the government's pre-occupation with quick results virtually ruled out market-oriented reforms, since letting market forces work through the system would have inevitably taken longer to produce results. In addition, interviewees noted that the *Association of Hospitals* proved to be very skilful in exploiting populist sentiments to fight off attempts to spread cost saving measures more evenly among all participants in the health care sector<sup>63</sup>. One executive remarked that

“it’s one thing to introduce a price freeze which reduces firms’ profits and quite another to close a hospital bed. While both help to reduce health care costs, the former is likely to be applauded by the population at large, while the latter is political suicide”<sup>64</sup>.

In other words, popular opposition to health care policies that aimed to spread cost saving measures more evenly, was an important factor behind the three MNEs' failure to persist with their preferences.

Finally, the increasing extent of the three MNEs' internationalisation process was not a source of political leverage in this policy area since there was no direct link between drug prices and production conditions. As one executive put it, “even if we shift production abroad, we still need to sell drugs in Germany”<sup>65</sup>. In view of these factors, it seems unlikely

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<sup>63</sup> Interviews.

<sup>64</sup> Interview.

<sup>65</sup> Interview.

that a high-profile public campaign similar to that in biotechnology, would have made much difference with regard to the two policy outcomes<sup>66</sup>.

Turning now to the 1990 *Gene Technology Act*, circumstances were also, at least initially, not particularly favourable for the three MNEs. A number of studies have noted that a highly negative public opinion regarding biotechnology prevailed in Germany during the late 1980s and early 1990s and that this factor played an important role in shaping the 1990 *Gene Technology Act*<sup>67</sup>. In fact, some authors have explicitly argued that the 1990 *Act* was driven by the government's desire to respond to the critics of biotechnology<sup>68</sup>. The favourable economic climate prevailing at the end of the 1980s also influenced the policy-making debate: as economic growth seemed secure, industry's concerns did not carry a lot of weight in the policy-making debate<sup>69</sup>. Also, by the late 1980s, the three MNEs could not credibly play the internationalisation card since most R&D and other high value-added activities were still pre-dominantly carried out in Germany (see Chapter 2). Hence the threat to shift production abroad did not seem particularly credible.

However, this state of affairs began to change in the first half of the 1990s. As the post-unification boom gave way to recession and economic growth declined sharply, general concerns regarding the quality of the German production location prompted a re-evaluation of the chances and risks of biotechnology<sup>70</sup>. In fact, a number of authors have argued that the economic crisis of the early 1990s created a "policy window" that the industry managed to exploit for the deregulation measures included in the 1993 revision of the *Gene Technology Act*<sup>71</sup>.

Of course, this raises the question why worsening economic conditions and competitiveness concerns did not create a similar window of opportunity for the three MNEs with regard to the 1993 health care reform. MNEs' internationalisation process suggests a plausible answer. Chapter 2 has shown that starting in the early 1990s, the three MNEs began to increasingly internationalise production and R&D activities. Hence the possibility that industry might respond to unfavourable regulations with further production relocations became increasingly real. In fact, a number of authors have argued that during the early

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<sup>66</sup> Interviews.

<sup>67</sup> See Winter (1992), Hoffmann (1997), pp. 235ff, EuropaBio (1997), p. 50 and Boston Consulting Group (1997), p. 115.

<sup>68</sup> See for example Gottweis (1992), p. 28 and Lange (1994), pp. 143f.

<sup>69</sup> See Bandelow (1999), p. 109.

<sup>70</sup> See Binet (1997), p. 8.

<sup>71</sup> See for example Binet (1997), p. 8, Bandelow (1997), pp. 161f, Bandelow (1999), pp. 134,128, Brauer (1993), pp. 121-124 and Winnacker (1993), p. 590.

1990s both the government and the SPD – the main opposition party - began to realise that a failure to improve regulatory conditions for biotechnology was likely to result in employment being shifted to foreign, more biotechnology-friendly production locations. As a result, domestic power constellations between industry, government and anti-biotechnology interest groups began to change in favour of firms<sup>72</sup>.

With regard to parallel imports, it was noted that the German government only undertook tentative measures to improve the situation in the second half of the 1990s; the most significant policy initiative was the 7<sup>th</sup> Amendment to Germany's Social Code (SGB V), which repealed provisions for the promotion of imported medicines<sup>73</sup>. Explaining the three MNEs' failure to achieve somewhat more decisive measures has been complicated by an additional factor. One association official noted that the main problem with improving the situation in this policy area has been that decision-making competence was somewhat unclear<sup>74</sup>. In the words of another official,

“essentially the German government and the European Commission have been playing a blame game. The government took the line that the problem lay with the single market and hence with the Commission. However, the Commission argued that the problem originated with member states' health care policies – an issue area in which it has no policy mandate”<sup>75</sup>.

In short, an analysis of the political influence of Hoechst, Bayer and BASF has clearly shown that the explanatory power of interest- and institutions-based explanations can be enhanced by incorporating changing economic and political circumstances into the analysis. It was shown that with regard to health care policies and biotechnology regulations, the impact of circumstances on government preferences, the opposition from other domestic groups and the extent to which MNEs' internationalisation process was a source of political leverage, significantly conditioned the political influence that MNEs were capable of exerting. Hence the evidence from the German pharmaceutical sector fits in well with the argument of Chapter 1 that institutional- and interest-based explanations need to be

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<sup>72</sup> See Dolata (1996), p. 164-180 and Bandelow (1999), pp. 107-110. See also Greenwood and Ronit (1994), Hey and Brendle (1994) and Greenwood (1995).

<sup>73</sup> See VFA Annual Report (1997), p. 3f.

<sup>74</sup> Interview.

<sup>75</sup> Interview.

supplemented by an analysis of the changing economic and political circumstances under which policy-making took place.

## **The Three Swiss MNEs: Roche, Ciba-Geigy and Sandoz**

As has been pointed out in Chapter 1, health care reforms, biotechnology regulation and intellectual property rights issues also topped the political agendas of Roche, Ciba-Geigy and Sandoz. As a non-member of the EU, Switzerland was less affected by parallel imports from EU countries and the issue was not mentioned in interviews as an area of major concern.

Intellectual property rights issues are a bit of an oddity in the Swiss context. Although Switzerland is not a member of the EU, the three MNEs chose to concentrate their political efforts with regard to these issues in Brussels. The interviewed executives argued that the European level was far more relevant in this issue-area since they preferred to register their patents at the European Patent Office in Munich (a European patent extends patent protection to all European countries and thus saves time and costs). Since Switzerland is a member of the European Patent Convention, a European patent is also upheld in Switzerland. Also, Swiss patent laws are expected to fall in line with policy decisions taken at the European level<sup>76</sup>. Hence the Swiss MNEs' political influence in this issue area will be analysed together with the German MNEs in Chapter 7.

### **Health Care Policy Issues**

As mentioned earlier, health care policies largely determine the prices that pharmaceutical MNEs can charge for their products. Hence it was not surprising that executives at Roche, Ciba-Geigy and Sandoz all referred to health care policy issues as one of the most important policy areas affecting their industry<sup>77</sup>. Like Germany, Switzerland embarked on a

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<sup>76</sup> Interviews. Büchel and Brauchbar (1997, p. 9) have pointed out that by 1997 there were only 11 biotechnology patents registered in Switzerland, since most companies preferred to register their patents with the European Patent Agency (EPA) in Munich.

<sup>77</sup> Although all three MNEs sell only a minuscule share of their drugs in Switzerland, health care policy issues are nevertheless of great significance for them; many foreign countries use the Swiss price as a reference price and hence prices at home have a significant multiplying effect. See Hill (1992), p. 7.

comprehensive health care reform during the last decade (in 1994) and the following section will now analyse the extent to which the three MNEs were able to shape this reform according to their preferences.

Operating conditions prior to the *Reform Act* were far less advantageous for the three Swiss MNEs than for their German counterparts. Unlike in Germany, drug prices were highly regulated in Switzerland. Until 1995, no fewer than three federal agencies were involved in the price-setting process: the *Federal Office of Social Insurance (BSV)*, the *Interkantonale Kontrollstelle für Heilmittel (IKS)*, and the office of the “price watcher”, a federal agency overseeing prices<sup>78</sup>. While it has often been pointed out that Swiss drug prices were in an international comparison high, it has much less often been mentioned that innovative drugs were severely disadvantaged by this pricing system since it benefited older drugs at the expense of new ones<sup>79</sup>. In fact, Hill has noted that

“the Swiss system of price controls had rather paradoxical consequences for a country with a strongly research-intensive pharmaceuticals industry: in an international comparison, prices for new and innovative drugs were relatively low, while prices of older drugs were comparatively high”<sup>80</sup>.

As a result, the Swiss pharmaceutical industry was strongly in favour of reforming the system so that innovation could be better rewarded<sup>81</sup>.

Like the German MNEs, the three Swiss MNEs were well positioned to exert political influence. In line with Switzerland's decentralised policy-making system, non-governmental actors feature prominently in the health care policy making-process. The three pharmaceutical MNEs are represented by the *Association of the Swiss Chemical Industry (SGCI)*, which is a member of the *Vorort*, and by *Interpharma*, the association grouping the pharmaceutical divisions of the three MNEs. Apart from the industry associations, the health care policy-making process also includes the associations of insurance companies, hospitals

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<sup>78</sup> For a more detailed description see Hill (1992) and Leutenegger (1993), p. 35.

<sup>79</sup> See Hill (1992), p. 7.

<sup>80</sup> Ibid., p. 11. This phenomenon can be explained by three factors: prices of “me-too” products (drugs with a low degree of innovation) were determined with reference to already approved drugs, prices for generic drugs had to be only 25 per cent below the price of the original product and the modus vivendi of price adjustments allowed almost automatic periodical increases. See Hill (1992), p. 7.

<sup>81</sup> See for example Humer (1997), p. 70.

and pharmacists, as well as the *BSV*, *IKS* and representatives from the federal and *cantonal* governments. The administration of the system is carried out by the *cantons*<sup>82</sup>.

Although Switzerland's health care system places considerably less emphasis on equity and solidarity than other European countries' systems<sup>83</sup>, Swiss health care costs nevertheless strongly increased in recent years. In 1990, Switzerland spent 7.5 per cent of its GDP on health care - a figure that had risen to 10 per cent by 1995. Without reform of the system, costs were estimated to increase to 15 per cent of GDP by the end of the 1990s<sup>84</sup>. In fact, since the late 1980s, the federal government was unable to fulfil its constitutional obligation to finance the health care system through subsidies, which led to a significant rise in insurance premiums<sup>85</sup>. As in most other industrialised countries, this development can be traced back to strongly distorted incentive structures. Hill has observed that there was no real market for drugs since doctors were free in their prescription practices, patients bought a whole package of health care services with their premiums and insurance companies converted higher expenditures into higher premiums<sup>86</sup>. Other authors have pointed out that the Swiss drug market's incentive structure was characterised by almost unlimited growth incentives and that as a result consumers were increasingly defining their needs by what was available<sup>87</sup>. In order to tackle these problems and contain rising health care costs, the Swiss government submitted various reform proposals in 1992, which led to the 1994 *Health Care Reform Act*.

Switzerland's *Reform Act* differed considerably from the two German reform acts. Unlike the German reforms, the Swiss *Health Care Act* avoided crude interventionist measures and policy-makers seemed to be aware that administered prices were unlikely to lead to sustained cost savings and would only trigger distortions elsewhere<sup>88</sup>. Instead, the central feature of the *Reform Act* was a price-setting system for drugs based on a comparison with three countries with similar economic structures: Germany, Denmark and the Netherlands. Rather than setting prices unilaterally, the *BSV* and *IKS* would henceforth orient themselves by average

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<sup>82</sup> See Hoffmeyer (1993), p. 16 and Hill (1992), p. 28.

<sup>83</sup> Switzerland's health care system allows insurance companies to calculate their premiums on the basis of individual risk. Rather than being related to income, as in other European countries, premiums are determined on the basis of, for example, age, regional cost differences and until recently sex. Federal and cantonal governments contribute to health insurance premiums, which in comparison with other countries reach substantial sums. Hoffmeyer has observed that in some ways the Swiss health care system was closer to the US model than to those of other European countries. See Hoffmeyer (1993), pp. 13, 28.

<sup>84</sup> See Hoffmeyer (1993), p. 14.

<sup>85</sup> Ibid., p. 15.

<sup>86</sup> Hill (1992), p. 9.

<sup>87</sup> See for example Brandt (1990), p. 17 and Sommer (1986), p. 235 and (1997), p. 8f.

<sup>88</sup> See Sommer (1997), p. 14.

prices from these three countries. The implications for the three MNEs were significant since the reform led to a substantial reduction of prices for "out of patent" drugs. *Interpharma* estimated that the pharmaceutical industry would lose SFr. 500m in sales over the next five years<sup>89</sup>. However, in return the *Reform Act* promised to improve innovation premiums for new drugs. Indeed, Roche's CEO Humer observed that the health care reform did not only lead to lower prices but also to higher ones<sup>90</sup>.

Although the extent to which this reform was market-conforming is certainly debatable (after all, drug prices in all three reference countries are considerably distorted through their exposure to parallel imports and market non-conforming regulations), it is generally looked upon as more liberal and flexible than the German reforms. *Interpharma's* general secretary, Thomas Cueni, commented that

"in comparison with dirigiste tendencies in Germany, France, Italy or the Netherlands, the Swiss model at least attempts to create market conditions through a price premium on innovation and through competitive pressure as a result of price comparisons with drug prices in other countries"<sup>91</sup>.

However, the reform has nevertheless been only a mixed success for the three MNEs. On the positive side, they were able to fend off proposals from the Associations of Pharmacists and Pharmaceutical Importers to establish a price model along German lines<sup>92</sup>. Moreover, the incentive structure of the Swiss health care market was certainly improved since older drugs became cheaper and innovative ones more expensive<sup>93</sup>. However, the reform was far from a success for the pharmaceutical industry. While the three MNEs commented that the new price model was a step in the right direction, they also stressed that the reform could only be an intermediary step on the way towards a more market-oriented health care system. Although prices remained flexible, the reform, from their viewpoint, essentially amounted to an introduction of parallel imports through international price comparisons, albeit with countries with similar economic structures, traditionally high drug prices and governments supportive of R&D<sup>94</sup>.

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<sup>89</sup> See *Interpharma* (1996), p. 1.

<sup>90</sup> Humer (1997), p. 61.

<sup>91</sup> See *Interpharma* (1996), p.1.

<sup>92</sup> See *Interpharma* (1996).

<sup>93</sup> See Humer (1997), pp. 57-61.

<sup>94</sup> Ibid., p. 65.

Chapter 3 has noted that Roche, Ciba-Geigy and Sandoz strongly favoured liberalisation measures that led to more competition, more choice for consumers and incentive structures that promoted cost-consciousness among all participants in the health care system. Put differently, they sought a reform that addressed the larger question of how health care services in general could be delivered more efficiently<sup>95</sup>. However, the reform did not address this major issue. The Swiss *Reform Act*, like the two German ones, focused cost saving measures disproportionately on the pharmaceutical industry even though drugs were neither the largest cost block in the health care budget nor the main cost driver. Not only did drugs account for a mere 8-10 per cent of overall health care expenditure over the last decade, but drug prices also rose more slowly than other expenditures. Between 1982 and 1992 Switzerland's drugs price index rose by only 24.7 per cent, while hospital costs in the same period increased by 93.1 per cent<sup>96</sup>.

### **Regulations relating to Biotechnology Issues**

In the Swiss case, two sets of biotechnology regulations need to be considered; one relating to drug approval procedures and one relating to the approval of production facilities and research projects. The following section will analyse the extent to which policy outcomes in these two policy areas corresponded to the six MNEs' preference for a regulatory framework that was predictable, transparent and based on scientific principles.

Swiss drug approval procedures were of central importance for Roche, Ciba-Geigy and Sandoz<sup>97</sup>. Although the three MNEs generally preferred to have their drugs approved by the EMEA (see Chapter 7), interviewees emphasised the importance of the Swiss drug approval system, since in many non-European countries the registration of a drug in Switzerland was still a pre-condition for approval<sup>98</sup>. Until the early 1990s, however, Switzerland's drug approval procedures were neither excessively predictable nor efficient. From the viewpoint of the three MNEs, approval procedures were over-regulated as new drugs had to be approved by two agencies, the IKS and the EAK (*Eigenoessische Arzneimittelkommission*). While the IKS generally accepted approval decisions taken at the EU level, the EAK proved to be more

<sup>95</sup> See *Interpharma* (1997).

<sup>96</sup> See Humer (1997), p. 70 and *Interpharma* (1996), p. 2.

<sup>97</sup> For the importance of Swiss drug approval procedures for the pharmaceutical industry see *SGCI Annual Report* (1989), p. 23.

<sup>98</sup> Interviews.

problematic. The result were times losses and unpredictability<sup>99</sup>. The decision-making process for setting prices was equally cumbersome as again two agencies were involved – the *IKS* and the *BSV* – with the result that new drugs could on average only be brought to the market one year after registration with the *IKS* and *EAK*<sup>100</sup>. Moreover, in 1989 the *IKS* introduced new guidelines for the approval of drugs, which were sharply criticised by the industry for being too unclear and too open to varying interpretations<sup>101</sup>.

However, during the 1990s there were significant improvements. In 1993, the *IKS* reformed its requirements for clinical tests in order to make them compatible with the EU's *Good Clinical Practice* guidelines – a reform that corresponded largely to industries' preferences and created the pre-conditions for international recognition of *IKS* research data<sup>102</sup>. Moreover, in 1995 the *IKS* gave up its role in the price-setting process in order to focus exclusively on safety concerns relating to new drugs<sup>103</sup>. As a result, approval processes were significantly speeded up. In 1997, Humer acknowledged that there had been tremendous improvements in the last couple of years and that with average approval procedures of six to seven months, the *IKS* belonged to the international top league<sup>104</sup>.

While the Swiss drug approval regime gradually improved during the 1990s, the opposite seems to have happened to regulations pertaining to the approval of production facilities and research projects. Until 1990 there was no formal legislation dealing with biotechnology in general and gene technology in particular as these issues were subject to self-regulation: firms and universities registered projects and production facilities voluntarily with the *Swiss Interdisciplinary Committee on Biological Safety in Research and Technology (SKBS)* – a body made up of representatives from science, industry and the state bureaucracy – which oriented itself by the guidelines from the OECD and the US National Institute of Health<sup>105</sup>. This regulatory regime corresponded largely to the three MNEs' preferences as it provided for transparency and involved only negligible levels of red tape.

However, during the late 1980s this lean regulatory structure became increasingly indefensible, as genetic engineering became politically highly controversial in Switzerland and the industry found itself the target of a broad spectrum of interest groups, ranging from

<sup>99</sup> Interviews. See also Humer (1997), p. 67.

<sup>100</sup> Interviews.

<sup>101</sup> See SGCI Annual Report (1989), p. 23.

<sup>102</sup> See SGCI Annual Report (1993), p. 27.

<sup>103</sup> See SGCI Annual Report (1994), p. 29.

<sup>104</sup> See Humer (1997), pp. 76f..

<sup>105</sup> See Binet (1997), pp. 58-61. See also Interview with Andres Leuenberger in *Basler Zeitung*, Jan. 5 1991.

consumer protection organisations to environmental groups and the church<sup>106</sup>. Particularly significant in this context was a large fire in 1986 at Sandoz's Schweizerhalle, which caused large chemical spillages into the Rhine and led to widespread mistrust towards new technologies<sup>107</sup>. Interest groups opposed to biotechnology began to proliferate and parliamentary groups such as the progressive organisations in Basle's cantonal parliament and the Social Democratic Group began demanding stringent restrictions on genetic engineering<sup>108</sup>. However, it was not just new interest groups such as the "*Basler Appell gegen Gentechnologie*", established in 1988, that opposed biotechnology; increasingly other organisations such as *WWF Switzerland* and the *Swiss Association for Nature Conservation* discovered a new *raison d'être* and jumped on the bandwagon<sup>109</sup>.

The first visible sign of this new movement were the protests against Ciba-Geigy's plan to build a *Biotechnikum* in Basle in 1990. The planning approval process was stretched out over two years due to numerous objections by individuals and interest groups, lodged with the building department of Basle City. Ciba won planning permission in July 1991, whereupon the *Basler Appell* went to court with the prospect of another three-year delay for Ciba. The company finally decided to cancel its plans for the *Biotechnikum* in Basle at the end of 1991. Arguing that the legal and political environment for genetic engineering was more favourable in France, Ciba decided to build the new facility just across the border in the Alsatian town of Huningue<sup>110</sup>. This incident was almost immediately followed by protests against experiments with genetically modified plants.

As legal uncertainty increased during the late 1980s and early 1990s, industry came round to accept formal regulation as a "necessary evil" to accommodate public opinion and to raise popular acceptance of biotechnology<sup>111</sup>. In order to minimise the disadvantages resulting from formal regulation, the three MNEs strongly stepped up their public relations efforts during this period. The centrepiece of this campaign was the *GenSuisse*, a foundation set up in 1991. Financed by *Interpharma* and composed of notables from the worlds of science and politics, the *GenSuisse* launched high-profile advertising and media campaigns to raise public acceptance of genetic engineering<sup>112</sup>.

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<sup>106</sup> For biotechnology-inspired popular fears and resistance see Straubli (1997), p. 5.

<sup>107</sup> See Binet (1997), p. 25.

<sup>108</sup> See Sally (1993), p. 572. For the politicisation of this issue due to popular mistrust see Cantley (1987).

<sup>109</sup> See Binet (1997), p. 68.

<sup>110</sup> See Sally (1993), pp. 572f. and Binet (1997), p. 66.

<sup>111</sup> See Binet (1997), p. 152 and Humer (1997), p. 84.

<sup>112</sup> See Sally (1993), p. 574 and Binet (1997), p. 153.

Industry's charm offensive was not without success. In contrast to Germany, Swiss regulations for the approval of production facilities and research projects turned out to be far less disadvantageous for the pharmaceutical industry. Although MNEs' preference for a maximum of flexibility was strongly opposed by environmental groups, which demanded a comprehensive law with a maximum of binding regulations<sup>113</sup>, industry preferences were to a significant degree taken into consideration. Instead of a comprehensive gene technology act along German lines, the Swiss regulatory system turned out to be a patchwork of various laws and voluntary guidelines, which continued to be administered by the *ZKBS* and which left firms considerable flexibility<sup>114</sup>.

The cornerstone of the new regulatory framework was a constitutional article referring explicitly to biotechnology, which was approved by referendum in 1992 (*Article 24 novies BV*). Within this framework, biotechnology was formally regulated through three laws: the “*Störfallverordnung*” (Emergency Safety Act), the revised environmental protection law and the revised food safety law. Although these three laws were also based on EU directives 90/219 and 90/220, their effects were very different compared to the German *Gene Technology Act*<sup>115</sup>. In stark contrast to Germany, the “*Störfallverordnung*” – the main legal device for the regulation of production and research facilities – did not regulate individual projects, but only required firms to submit information regarding safety concerns, possible risks and preventive measures<sup>116</sup>. Registration of biotechnology production facilities and projects continued to be carried out according to *SKBS* guidelines and was not required by law<sup>117</sup>. Along similar lines, the revised environmental protection law required pharmaceutical firms to exercise “controlled self-responsibility” and to undertake all measures to reduce risks resulting from gene technology<sup>118</sup>. While the revised environmental protection and the food safety law did require approval for projects involving genetically modified organisms, the *SGCI* pointed out that both laws struck a good balance between the protection of humans, animals and the environment, on the one hand, and the concerns of industry on the other<sup>119</sup>. Moreover, Swiss biotechnology regulations did not have the same devastating effect that regulation had in Germany and Switzerland remained a world-class research location. In

<sup>113</sup> For the demands of biotechnology opponents see Binet (1997), pp.156ff. and “Kritik der Schweizerischen Arbeitsgruppe Gentechnologie (SAG) und den Eurolex Gesetzesanpassungen”, *Neue Zürcher Zeitung*, July 3 1992

<sup>114</sup> See Straubli (1997), p. 17.

<sup>115</sup> *Ibid.*, p. 19f.

<sup>116</sup> Interviews. See also Binet (1997), p. 70.

<sup>117</sup> See Straubli (1997), p. 17.

<sup>118</sup> *Ibid.*

<sup>119</sup> See *SGCI* Annual Report (1995), p. 34. See also Binet (1997), pp. 72-74.

1997, an international comparative study ranked Switzerland first in immunology, molecular biology and pharmacology and second in biochemistry and microbiology.<sup>120</sup>

Nevertheless, problems have remained; a number of authors have pointed out that approval procedures were in practice slow and unpredictable<sup>121</sup>. Indeed, while the formal regulatory framework was not too unfavourable for the three MNEs, its interpretation often turned out to be quite a different matter. Like their German counterparts, executives at the three Swiss MNEs complained that under the pressure of an emotionally charged public opinion, the application of the new regulations was very restrictive and did not always seem to follow consistent criteria.<sup>122</sup>. Moreover, interest groups frequently did not accept policy outcomes and launched – or threatened to launch – referendums, which created highly unpredictable operating conditions for the pharmaceutical industry<sup>123</sup>. As Leuenberger has observed,

“the problem is that the opponents of gene technology do not accept ratified policies, but already plan new referendums. Just as the sovereign has decided a particular issue, these groups already start preparing new initiatives relating to the same issue. The fact that in Switzerland’s direct democracy one has to vote on everything not only once, but rather numerous times within a couple of years creates huge uncertainties”<sup>124</sup>.

For example, simultaneously with the 1992 ratification of *Article 24 novies BV*, the *Groupe de Travail sur LeGenie Genétique*, a coalition of 70 environmental protection, animal rights and other special interest groups with almost 500,000 members, launched the preparatory process of a referendum that advocated draconian regulatory measures<sup>125</sup>. Under the name “*Genschutzinitiative*” (Gene Protection Initiative), this initiative hung until its rejection in 1998 like a Damocles’ sword above the three MNEs and created huge uncertainties regarding the future of the Swiss research and production location.

<sup>120</sup> Quoted in Binet (1997), p. 92. See also Interpharma (1997).

<sup>121</sup> See for example Enright and Weder (1995), p. 7, Humer (1997), p. 70 and Sally (1993), p. 573.

<sup>122</sup> Interviews. See also “Der Standort Schweiz braucht die Gentechnologie”, *Neue Zürcher Zeitung*, June 24 1995.

<sup>123</sup> Binet (1997, p. 78) has argued that the problem for the pharmaceutical industry was not formal regulation, but rather public opposition and scepticism which resulted in referendums that created unpredictability. For example, in 1992, the Swiss population rejected a referendum on animal rights. However, this did not discourage the initiators to re-launch almost exactly the same referendum a year later. Although it was again rejected, it created delays and uncertainty for firms. See also SGCI Annual reports (1991, 1992 and 1993).

<sup>124</sup> Speech by Andres Leuenberger at the SGCI Annual Meeting 1992.

## The Political Influence of Roche, Ciba-Geigy and Sandoz: An Analysis

Compared to the German MNEs, the political influence of the three Swiss MNEs has been more substantial. Unlike their German counterparts, they did not suffer a major political defeat similar in scale to the German 1990 *Gene Technology Act* or the two German health care reforms. Their influence appeared to have been more subtle: while they did not get it their way completely, policy outcomes were by and large compromise solutions which tried to accommodate all affected interests. In other words, in line with the analysis of Chapter 4, the Swiss policy-making system of incremental progress appeared to have been functioning well.

With regard to health care reform, Switzerland's reform was essentially an attempt to control costs while simultaneously honouring innovation. While the cost-saving measures were certainly focused on the pharmaceutical industry, unlike the German MNEs, the three Swiss MNEs got something in return; the government promised to improve innovation premiums for new drugs. Commenting on this outcome, Humer pointed out that

“dialogue and search for a sensible compromise have a long tradition in Switzerland.

Following this tradition, Swiss firms have agreed to massively reduce the price of numerous drugs, despite being unhappy about the nature of the new price comparison system...The industry, however, welcomes the promise of the government to honour innovation in the future with a premium”<sup>126</sup>.

Quite plausibly one could make the same argument with regard to biotechnology regulations. After all, the various laws that make up Switzerland's regulatory framework were essentially all compromise policies, which tried to strike a balance between the concerns of industry and popular demands for formal regulation. Clearly, the new regulatory framework would not have been the three MNEs' first choice. However, it could have gone worse: interest groups demanded severe legislative restrictions, and in many cases outright bans on genetic engineering research<sup>127</sup>.

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<sup>125</sup> See Straubli (1997), p. 18.

<sup>126</sup> Humer (1997), p. 56.

<sup>127</sup> See Sally (1993), p. 571.

Having said that, however, there are limits to the extent to which these policy outcomes can be explained by Switzerland's compromise-reinforcing institutions. While certainly policy outcomes in biotechnology and health care have been compromise solutions, the compromise in biotechnology has clearly been more to MNEs' advantage than the health care compromise. In fact, Humer has noted that the governments' promise for an innovation premium got off to a bad start - judged by the evidence from 1996, there was little to suggest that innovation was rewarded with a premium<sup>128</sup>. How can one explain then these variations in MNEs' political influence?

As in the German case, interest-based explanations offer a seemingly plausible answer. With regard to the regulatory framework for biotechnology, the three MNEs launched a high-profile public campaign to promote their interests and the outcome was significantly closer to their preferences than in the health care reform where the three relied on traditional institutional linkages to the policy-making process to articulate their preferences. However, such an explanation is not entirely convincing. Again similar to the German case, the impact of economic and political circumstances on government preferences, domestic opposition and the extent to which the three MNEs' internationalisation process was a source of political leverage, significantly shaped the political influence that the three MNEs were capable of exerting.

In fact, with regard to the health care reform, circumstances were highly unfavourable for Roche, Ciba-Geigy and Sandoz. First, the Swiss governments' preferences were not entirely compatible with those of the three MNEs. While compared to the German government, the Swiss government acted more like an arbiter than an actor in the negotiations, it nevertheless had a strong preference for quick results as health care costs were spiralling out of control<sup>129</sup>. Interviewees generally argued that the Swiss government probably understood better than the German government that administered prices were unlikely to lead to sustained cost savings, but the need for imminent results made cost-saving measures focused on drugs the most feasible solution. As one executive put it,

"although the two failed German reforms served as a powerful warning and underlined the need for market-based reforms, the Swiss government was primarily interested in quick results and not in designing new market orders".

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<sup>128</sup> See Humer (1997), p. 60.

Second, there was strong opposition against market-based reforms from the *Association of Pharmacists* and the *Association of Pharmaceutical Importers*, which preferred a dirigiste reform model along German lines<sup>130</sup>. Moreover, the *Association of Hospitals* strongly opposed any reforms to spread cost-cutting measures more evenly among all health care sector participants<sup>131</sup>. As in the German case, executives from the three MNEs conceded that although the hospital sector was the main cost-driver behind rising health care expenditure, it was a political non-starter to try to include this sector in reform measures. In the words of one interviewee,

“reducing hospital beds is always bad politics - no matter how large the over-capacity in this sector is - while redistributing profits from the industry is always good politics”.

Finally, MNEs’ internationalisation process did not translate into increased political influence in this policy area since there was no direct link between drug prices and production conditions. Against this background, it seems somewhat implausible to argue that a more forceful articulation of interests - similar to that in biotechnology - would have led to a more industry-friendly policy outcome.

With regard to biotechnology regulations, circumstances were a lot more favourable for the three MNEs. A number of authors have argued that despite strong opposition from organised interests, economic considerations came increasingly to dominate the discussion surrounding biotechnology<sup>132</sup>. Binet noted that this development started with Ciba’s decision to build its *Biotechnikum* just across the border in France<sup>133</sup>; commenting on the political effects of Ciba-Geigy’s decision, one interviewee argued that “policy-makers began to recognise the mobility of this industry with all its implications for Swiss welfare”. Within this context, the three MNEs’ internationalisation process has been highly significant. Chapter 2 has noted that starting in the late 1980s and early 1990s, all three MNEs began to increasingly internationalise R&D and high-value added production activities. In parallel, overall economic growth in Switzerland stagnated, unemployment became a serious problem for the first time since World War II and general concerns regarding Switzerland’s long-term economic prospects began to emerge (see Chapter 4). As a result of these developments,

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<sup>129</sup> Interviews.

<sup>130</sup> See Interpharma (1996).

<sup>131</sup> Ibid.

<sup>132</sup> See for example Binet (1996), SPP BioTech and Biotectra (1996), Arvanitis and Schips (1996) and Spaar (1996).

policy-makers became increasingly aware of the economic costs associated with strict biotechnology regulations<sup>134</sup>.

In short, compared to Germany, institutions played a more important role in the explanation of the three Swiss MNEs' political influence. It was shown that policy outcomes in health care policy and biotechnology were essentially compromise solutions that tried to accommodate all affected interests. Nevertheless the nature of the two compromises differed considerably: the "biotechnology compromise" was more a lot more favourable for the three MNEs than the "health care compromise". An analysis of economic and political circumstances could explain why MNEs were capable of exerting more political influence with regard to biotechnology regulations than with health care policy. In this sense, the evidence from the Swiss pharmaceutical sector also fits in well with the argument of Chapter 1 that institutional- and interest-based explanations need to be supplemented by an analysis of the circumstances under which policy-making took place.

## Conclusion

A review of recent policy outcomes in the German and Swiss pharmaceutical sector clearly showed that sweeping statements about the supposedly overwhelming political power of MNEs in an age of globalisation are largely misplaced. All six MNEs are highly internationalised and yet policy outcomes in both countries were far from conforming with their preferences. This has been particularly true for the German MNEs, which suffered significant political defeats.

Generally, the findings of this chapter have supported the hypotheses raised in the previous chapters. Chapter 1 has argued that interests and institutions were important for an explanation of MNEs' political influence. However, it was suggested that an analysis of the economic and political circumstances under which policy-making took place could enhance the explanatory power of the two approaches. It was argued that the impact of these circumstances on the preferences of the government, the extent of opposition from other domestic groups and MNEs' internationalisation process were important conditioning factors. The policy outcomes reviewed in this chapter have confirmed this hypothesis. Changing

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<sup>133</sup> Binet (1997), p. 65.

circumstances had indeed a significant impact on the political influence that MNEs were capable of exerting.

Moreover, Chapter 4 noted that some authors have recently diagnosed cracks in Germany's institutional structure, while in the Swiss case it was generally argued that institutions had remained intact. On this basis, it was predicted that institutions were likely to be of greater importance for an analysis of the Swiss MNEs' political influence, as they could still be expected to lead policy-making processes in the direction of compromise solutions. Indeed, that turned out to have been the case. Both in biotechnology and health care, the three Swiss MNEs did not have it entirely their way, but their interests were taken into consideration to a not insignificant degree and the final policy outcomes tried to balance the interests of all affected groups. In contrast, policy outcomes in Germany could hardly be labelled compromise solutions, but rather seemed to fit in well with the studies that were sceptical about the continued capacity of Germany's institutions to shape policy-making processes.

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<sup>134</sup> Ibid., pp. 4, 161.

# 6

## The Political Influence of the Six German and Swiss Banks

The purpose of this chapter is to analyse and explain the political influence of the six German and Swiss banks with regard to the selected policy issues. Similar to the previous Chapter, the analysis will build on the findings of Chapter 3, which has analysed banks' economic policy preferences. Comparing these preferences with actual policy outcomes will provide a yardstick by which the extent of banks' political influence can be measured. However, just as in the case of pharmaceuticals, such a comparison is unlikely to *explain* banks' political influence by itself since it is hardly plausible to assume that banks' influence will be a neat function of their interests. Institutions that link banks to the policy-making process may also be a source of political influence. Chapter 4 has shown that the business community in both Germany and Switzerland is part of an institutional structure that provides firms and banks with strong linkages to the policy-making process. Moreover, as has been argued in chapter 1 - and shown in chapter 5 – changing economic and political circumstances may have an impact on the preferences of the government, the degree of opposition from other organised groups and the extent to which MNEs can use their internationalisation process for political leverage. The following sections will now analyse how all these factors have come together to shape the political influence of the six German and Swiss banks with regard to the selected policy issues.

### The German Banks: Deutsche Bank, Dresdner Bank and Commerzbank

As has been pointed out in Chapter 1, executives at the three banks and the *Federal Association of German Banks (FAGB)* noted that the most important policy issues during the period from 1985 to roughly 1995 centred around market access issues, public ownership of

banks and regulatory issues. However, not all of these issues will be analysed in this chapter. As a result of the Single Market programme's goal to create a unified European capital market, market access issues became increasingly the subject of European directives and hence will be analysed in Chapter 7. The second market access issue – the GATS Agreement for Financial Services – also fits better in Chapter 7 as the European Commission was (at least partly) negotiating on member states' behalf<sup>1</sup>.

### **Banking Regulation**

Chapter 3 has argued that the nature of banking regulations profoundly affects the extent to which the allocation of capital and risks can be carried out according to market principles. In Germany, the banking regulatory framework is essentially market conforming; it regulates and supervises banks to ensure the safety and soundness of individual banks and of the system as a whole and does not deal with issues such as fair lending practices or community reinvestment records<sup>2</sup>. However, regulations have also been market non-conforming in the sense that they have made it difficult and expensive for banks (and firms) to adjust to the age of securitisation in which capital is raised directly from capital markets. As Fassbender has argued,

“historically the German financial markets relied on loans and not capital markets for the allocation of capital. Indeed for generations, banks and clients have shown a preference for intermediation. These preferences developed into habits and institutions, and into regulations and taxation policies with the result that the regulatory environment made it difficult and expensive for banks and companies to take advantage of the new trends of securitisation and disintermediation”<sup>3</sup>.

Seifert added that by the early 1990s Germany's capital markets were still considerably over-regulated, which resulted in high transaction costs, discouraged companies from going public, prevented the introduction of new financial instruments and depressed domestic demand. Moreover, regulations dealing with transparency and disclosure requirements were not

<sup>1</sup> While the EU Commission has exclusive competence on traditional GATT issues (i.e. trade in goods), it shares negotiating competence with member-states on “new issues”.

<sup>2</sup> For the objectives of German banking regulations see Niethammer (1990).

considered as *en par* with international best practices and were generally seen as undermining investor confidence. Finally, a central investor element – the pension fund – was (and still is) de facto non-existent<sup>4</sup>.

These inadequate framework conditions have been largely blamed for Germany's failure to develop an investment culture similar to Anglo-Saxon countries and to adjust to the age of securitisation. In 1994, German households held only 24 per cent of their assets in securities and funds, compared to 39 per cent in the US. If one included indirect ownership of securities through life insurance and pension funds, Germany's share increased to only 37 percent compared with 64 per cent in the US and 60 per cent in Great Britain. Moreover, Germans predominantly invested in treasury bonds so that the share of stocks amounted to merely 5 per cent of all private assets. In the US, this figure was 32 per cent in 1994 and in Great Britain 46 per cent. Unsurprisingly then, the market capitalisation of all German stock companies amounted to only 25 per cent of GDP, whereas in the US it amounted to 75 per cent. Moreover, it has been estimated that more than half of all German shares were not traded since the owners cared more about control of the respective company than adequate returns of investment<sup>5</sup>. The *FAGB* has complained many times that the failure to develop efficient capital markets has manifested itself in a lack of liquidity of the German capital market and, consequently, in prohibitively high capital costs for companies<sup>6</sup>.

Chapter 3 has argued that the increasing importance of securitisation gave the three banks a strong interest in policies aimed at the broadening and deepening of Germany's capital markets. Essentially the banks were well placed to promote this interest. In line with Germany's decentralised decision-making process, the German regulatory and supervisory structure consists of both public and private actors. The policy community includes the Federal Bank Supervisory Office (*Bundesaufsichtsamt für das Kreditwesen*), the Bundesbank, the Ministry of Finance and 14 banking associations. The three largest associations are those of the commercial banks (*Federal Association of German Banks*), the savings banks (*German Savings Bank and Giro Association*) and the co-operative banks (*Federal Association of German Co-operative Banks*)<sup>7</sup>. De jure, the Berlin-based *FSBO* is the primary German bank regulatory and supervisory authority. Only the *FSBO* may issue

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<sup>3</sup> See Fassbender (1995), p. 5.

<sup>4</sup> Interview with Werner Seifert, CEO of Deutsche Börse, *Frankfurter Allgemeine Zeitung*, June 5 1996. See also "Der Finanzplatz muss attraktiv bleiben", *Börsenzeitung*, March 1 1997 and "Kapitalmarktkultur entwickeln", *Börsenzeitung*, Dec. 4 1997.

<sup>5</sup> See Fassbender (1995), p. 7f. and "Kapitalmarktkultur entwickeln", *Börsenzeitung*, Dec. 4 1997.

<sup>6</sup> See for example *FAGB* Annual Report (1998), p. 46.

banking regulations, issue or revoke bank licenses, and take enforcement actions against banks<sup>8</sup>. As a government agency reporting directly to the Ministry of Finance, the FSBO is held accountable for its actions to the German parliament. However, the Bundesbank is also highly influential and one can observe a *de facto* sharing of regulatory responsibilities. As a briefing paper prepared by the *Bundestag* has pointed out,

"In practice, the opinions of the Bundesbank carry significant weight. We were told that the FBSO has never issued regulations with which the Bundesbank strongly disagreed. This effort towards consensus can partially be attributed to a recognition of the importance of a united Bundesbank-FBSO position if particular regulations were to be challenged by the banking industry in the strong German administrative court system...Despite the difference in their legal responsibilities, the FSBO and the Bundesbank work closely together and are considered partners in the formulation of regulatory and supervisory policies"<sup>9</sup>.

The Bundesbank is also involved in the development of legislation. Although technically the Finance Ministry is responsible for developing banking related legislation, it often draws on the Bundesbank to help draft banking laws<sup>10</sup>.

However, the bank associations also play an important role in developing laws and regulations. Federal law stipulates that the Finance Ministry and the bank regulators must consult the bank association when changes to banking laws or regulations are being considered and before banking licenses are issued<sup>11</sup>. Moreover, the three largest bank associations administer three separate deposit insurance systems<sup>12</sup> and act through the Liquidity Consortium Bank (LIKO) as the lender of last resort. In this context, the bank associations have the power to intervene in banking crises and to assist troubled banks or liquidate failed banks<sup>13</sup>.

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<sup>7</sup> See FBSO (1995), p. 10.

<sup>8</sup> Ibid., p. 16

<sup>9</sup> See FBSO (1995), p. 20.

<sup>10</sup> Ibid., p. 39.

<sup>11</sup> Ibid., p. 30.

<sup>12</sup> The German deposit insurance systems are private and membership is optional. There is no federal deposit insurance program and no federal guarantee of the private systems. With very few exceptions, all banks in Germany are members of a deposit insurance system. See FBSO (1995), p. 29.

<sup>13</sup> See FBSO (1995), p. 30.

Turning now to policy outcomes regarding Germany's regulatory framework, the first half of the 1990s differed strongly from the 1980s. While the 1980s were characterised by inertia when it came to reforms of Germany's banking regulations, the early 1990s saw a flood of policy initiatives. Arguably of greatest significance were two *Financial Market Promotion Laws* (*Finanzmarktförderungsgesetze*), which went a long way towards adjusting Germany's regulatory framework to the age of securitisation and disintermediation.

The first of these two laws (the *Second Financial Markets Promotion Law* or *Zweite Finanzmarktförderungsgesetz*) was ratified in 1994 and centred on improving investor confidence, creating a more innovation-friendly regulatory environment and adjusting German regulations to international standards<sup>14</sup>. A Bundesbank official noted that

“the law was driven by a realisation that German capital markets needed to attract foreign capital and hence required internationally oriented regulations. Our aim was to ensure that German capital markets had a regulatory structure that would enable them to compete with the world's leading financial centres”<sup>15</sup>.

To this end, the law included several measures to improve transparency and to assure foreign investors of equal treatment. Particularly important in this respect were new rules for insider trading, which replaced the voluntary guidelines of the *FAGB*<sup>16</sup>. Transparency was further strengthened through the establishment of a new supervisory authority for the stock exchange (*Bundesaufsichtsamt für das Wertpapierwesen*). Although the law formalised a number of previously informal guidelines administered by the *FAGB*, the three banks strongly supported it. One bank executive noted that “the increased involvement of the state in some areas was absolutely necessary for establishing an internationally competitive regulatory framework. In fact, during meetings with the regulators, the *FAGB* was strongly in favour of a more formalised regulatory structure”. Indeed, the *FAGB* referred to the law as a milestone on the way towards well-functioning capital markets<sup>17</sup>, and Seifert commented that the law gave German capital markets by international standards an adequate supervisory structure<sup>18</sup>.

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<sup>14</sup> See *FAGB Annual Report* (1998), p. 34.

<sup>15</sup> Interview.

<sup>16</sup> See *FAGB Annual Report* (1998), p. 30.

<sup>17</sup> See *FAGB Annual Report* (1996), p. 65 and (1998), p. 30.

<sup>18</sup> Interview with Werner Seifert, CEO of Deutsche Börse, *Frankfurter Allgemeine Zeitung*, June 5 1996.

Shortly after passing this law, the German government ratified the *Third Financial Markets Promotion Law*, which centred on improving companies' access to capital markets<sup>19</sup>. To this end, the law cut a lot of red tape in order to make it easier for companies to obtain stock market listings. For example, the requirement to hold annual meeting was abolished and regulations pertaining to the publication of prospectuses in official documents were significantly eased. As a result, issuing debt became a lot easier for companies. Trivial as these measures may sound, they abolished significant disadvantages compared to other European financial centres<sup>20</sup>. The law also included a provision to make it easier for German companies to raise capital on international markets (*Kapitalaufnahmeverleichterungsgesetz*), as German regulators agreed - within limits - to accept international accountancy standards. Moreover, the act modernised German investment laws by allowing share buy-backs and the relatively swift approval of innovative financial instruments. Finally, the German stock exchange was allowed to significantly extend its range of derivatives by adding a whole range of new futures<sup>21</sup>. Bank and association executives noted that the *FAGB* commented frequently on draft proposals of this law and that association input was incorporated to a significant extent<sup>22</sup>. Moreover, the law sparked a discussion within the previous government of how to further deepen and broaden German capital markets; a *Fourth Financial Markets Promotion Law* will examine whether to allow Anglo-Saxon style pension funds<sup>23</sup>.

In addition to these two laws, Germany's supervisory structure underwent significant changes during the 1990s. As has been pointed out above, and will be elaborated in Chapter 7, the European Commission issued a number of directives during the late 1980s and early 1990s to establish a common European supervisory structure as a precondition for a unified European capital market. These directives were incorporated into German banking laws through so-called *Novellen* (revisions). While previously such revisions had only rarely occurred (in 1961, 1974 and 1984), the 1990s saw three *Novellen*: one in 1993, one 1996 and one in 1998. The purpose of these revisions was to address and modernise key supervisory issues such as the definition of capital and financial services firms, banks' propriety trading, the extension of supervision to new financial products and risks, risk management models

<sup>19</sup> For a detailed summary of the law see *FAGB* Annual Report (1998), pp. 53-58.

<sup>20</sup> See *FAGB* Annual Report (1994), p. 33.

<sup>21</sup> See *FAGB* Annual Report (1994), p. 32 and "Novelty of the short-term", *Financial Times*, Sept. 26 1994.

<sup>22</sup> Interview. The *FAGB*'s 1998 Annual Report explicitly praised the close co-operation between the *FAGB*, the Finance Ministry, the Bundesbank and FBSO for the drafting of the two financial market promotion laws. See *FAGB* Annual Report (1998), p. 53.

<sup>23</sup> See "Bonner Entwicklungshilfe für den deutschen Kapitalmarkt", *Frankfurter Allgemeine Zeitung*, March 3 1996.

and measures against money laundering<sup>24</sup>. The intention behind these revision was, however, not just to comply with EU requirements for a unified European capital market, but also to adjust the German supervisory structure to the international norms and standards proposed by the *Basle Committee* (see Chapter 7). The *FAGB* noted that while previous revisions were motivated by purely national considerations, the revisions of the 1990s were a response to the increasing internationalisation of capital markets, which required an internationally oriented supervisory structure<sup>25</sup>. The three banks generally welcomed all of the revisions since they were explicitly aimed at ensuring distortion-free competition and the strengthening of the financial system<sup>26</sup>. An association official commented that the *FAGB* had been working closely together with the regulators on how EU directives were best incorporated into German laws.

Apart from these major initiatives, there were, however, also a number of other important measures that, taken together, significantly improved the functioning of the German capital market and improved efficiency and liquidity. First of all, after intensive lobbying by the *FAGB*, taxes on stock market transactions were abolished in 1990. One executive noted that this was a major success for the three banks as it removed a significant disadvantage compared to other financial centres<sup>27</sup>.

Second, the technical infrastructure of the German stock exchange in Frankfurt strongly improved during the 1990s. Germany's futures exchange *Deutsche Terminbörse (DTB)* began to offer remote membership and to develop a reputation as one of the world's most sophisticated exchanges<sup>28</sup>. The German stock exchange has with *XETRA* one of the world's leading electronic trading systems and forged during the second half of the 1990s alliances with the London Stock Exchange and the Chicago Board of Trade<sup>29</sup>. Significant in this context has also been the establishment of Frankfurt's *Neuer Markt* exchange, which has had some success in bringing young companies to the market and in attracting new equity investors. The market has stressed transparency, made companies publish prospectuses in English and used American accounting standards<sup>30</sup>.

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<sup>24</sup> See *FAGB Annual Report (1998)*, p. 40.

<sup>25</sup> *ibid.*, p. 42.

<sup>26</sup> See *FAGB Annual Report (1994)*, pp. 54-59 and *Annual Report (1996)*, pp. 96-102.

<sup>27</sup> Interview.

<sup>28</sup> Interviews.

<sup>29</sup> See *FAGB Annual Report (1998)*, p. 58. See also "No SECs please, we're European", *The Economist*, August 21 1999, pp. 70f.

<sup>30</sup> See "No SECs please, we're European", *The Economist*, August 21 1999, p. 70f.

Reflecting on the reforms during the 1990s, the *FAGB* noted that during the last decade framework conditions improved strongly with the effect that the German financial centre became more dynamic and more attractive for foreign investors<sup>31</sup>. As a result, a substantial amount of business that German banks had shifted to London in the early 1990s, began to return to Frankfurt<sup>32</sup>. One bank executive commented that "framework conditions of Germany's capital markets have continuously improved during the last years and have in the process become a lot more internationally- and market-oriented"<sup>33</sup>.

### Public Ownership of Banks

A particular characteristic of the German banking sector is the relatively large market share of state owned banks. For historical reasons, mainly connected with the need to reconstruct Germany after the Second World War, the public sector plays an unusually prominent role in the German banking sector. The nation's 13 *Landesbanken* alone command a share of about 14 per cent in the market for domestic credit, while the almost 600 local public sector banks – known as the *Sparkassen* – have another 23 per cent. In 1998, public sector banks accounted for half of the total turnover of Germany's banking sector: Moreover, as the private sector banks have repeatedly stressed, these banks appear on the market with common products and common advertisements; in other words, they are everything but competitors. By contrast, the three *Grossbanken* – Deutsche Bank, Dresdner Bank and Commerzbank - compete fiercely against each other and together account for only 15 per cent of the turnover in the German banking sector<sup>34</sup>.

Throughout the late 1980s and 1990s, Germany's private banks have been repeatedly complaining to the German government about the competition distorting effects that result from these extensive state activities<sup>35</sup>. Their criticism has been particularly directed at the *Landesbanken* – the traditional clearing banks for municipal savings banks and financiers of their state governments. As long as the *Landesbanken* kept off the turf of their commercial rivals and confined their business activities to their original task, criticism from the private

<sup>31</sup> See *FAGB* Annual Report (1998), p. 53.

<sup>32</sup> See *FAGB* Annual Report (1998), p. 58. See also "Finanzplatz Frankfurt hat sich stetig verbessert", *Börsenzeitung*, Feb. 1 1995.

<sup>33</sup> Interview.

<sup>34</sup> See *FAGB* Annual Report (1998), pp. 44f and "EU scrutiny of German public bank system arouses passionate defence", *Financial Times*, August 17 1999.

banks remained relatively muted. When, however, during the 1990s some of the *Landesbanken* expanded into investment banking and asset management and started to set up international branches<sup>36</sup>, criticism from private banks in general, and the three *Grossbanken* in particular, increased sharply.

Two issues have been particularly contentious. First, the three banks complained that the state has provided the *Landesbanken* with capital on subsidised terms. In 1993 the EU ratified a directive for capital adequacy standards which significantly raised the standards for Germany's banks. While the private banks were forced to issue more equity in order to raise additional funding, in six German *Länder* the state governments transferred funds from building agencies to their *Landesbanken*. For the banks in question the net effect was a subsidy totalling DM11.4bn<sup>37</sup>. One bank executive argued that "without this capital injection, most *Landesbanken* would have had to reduce the scope of their businesses".

Second, the commercial banks complained that the *Landesbanken* enjoyed an unfair competitive advantage since they have unlimited financial guarantees from their owners – the German *Länder* and ultimately the German government. This implicit public guarantee allows the public sector banks to raise capital cheaply and hence to refinance their lending at a lower cost than private sector banks. In fact, despite inadequate capital strength levels and wafer thin margins – on average the *Landesbanken* make an average return of equity of around 5 per cent – the *Landesbanken* generally carry the same credit rating as the states that back them, which is usually the highest one (AAA). By one estimate, it costs the biggest *Landesbanken* 15 basis points (hundredths of a percentage point) less than their private competitors to raise money. An internal study by the European Commission estimated the advantage at even DM 250m-500m for every DM100bn borrowed<sup>38</sup>.

Through the *FAGB*, the three *Grossbanken* have been intensely complaining that the activities of the state owned banks were highly competition distorting and had also negative implications for the creation of a European single market in financial services<sup>39</sup>. Indeed, it is often argued that the effect of state support for the *Landesbanken* is one of the most significant obstacles to the construction of a single European banking market as it skews the

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<sup>35</sup> See for example *FAGB Annual Report* (1998), pp. 44f.

<sup>36</sup> The most prominent of the *Landesbanken*, West LB, owns a fully fledged investment bank.

<sup>37</sup> See "Can Dachshunds be whippets?", *The Economist*, Jan. 4 1997.

<sup>38</sup> Quoted in "German banks under fire", *The Economist*, May 22 1999. See also "Can dachshunds be whippets?", *The Economist*, Jan. 4 1997.

<sup>39</sup> See *FAGB Annual Report* (1998), p. 47.

German market against foreign banks<sup>40</sup>. As has been pointed out in Chapter 3, the three banks have been strongly advocating legislation which would force the public sector banks to pay a market price for capital. These demands have, however, drawn an indignant response from the state-owned banks, which, in the words of one interviewee, contend

“that they are nothing like as inefficient as portrayed by their rivals and that they provide essential competition in the crowded German banking market. Moreover, they claim that public sector banks are an intricate part of Germany’s social market economy”<sup>41</sup>.

One bank executive countered that these arguments were not more sophisticated than the fear that losing the state guarantee would mean a sharp drop in credit rating and the loss of whatever franchise they still had<sup>42</sup>.

However, despite repeated criticism, the efforts of the *FAGB* to get the German government to level the playing field between Germany’s private and public sector banks were unsuccessful. The situation in 1995 did not differ from that in 1985. In the second half of the 1990s, the three *Grossbanken* stepped up their campaign and took the issue to the European level. In 1996, they launched a complaint with the European Commission on the basis of Article 92 of European competition law, which forbids state subsidies that lead to preferential treatment of particular firms, distortions of competition or negative implications for the single market<sup>43</sup>. As a result the Commission launched an investigation into the business affairs of West LB, the most prominent of Germany’s *Landesbanken*. With the investigation under way, other European banks increasingly joined the three German banks in their criticism of the *Landesbanken* and complained that as the *Landesbanken* ventured overseas, cheap finance on the back of their state guarantees gave them an unfair advantage. So far, however, the European Commission has avoided taking formal action in this politically sensitive area<sup>44</sup>.

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<sup>40</sup> See “EU attack on Germany set to create a furore”, *Financial Times*, Oct. 22 1999.

<sup>41</sup> Interview.

<sup>42</sup> Interview.

<sup>43</sup> See *FAGB Annual report* (1998), pp. 44f.

<sup>44</sup> See “German banks under fire”, *The Economist*, May 22 1999 and “Can dachshunds be whippets?”, *The Economist*, Jan. 4 1997.

## The Political Influence of Deutsche Bank, Dresdner Bank and Commerzbank: An Analysis

On balance, the three banks' political influence was clearly not insignificant. Policy outcomes corresponded in a number of issue areas closely to banks' preferences. While the three banks certainly suffered a political defeat by their failure to get the government to level the playing field between Germany's private and public sector banks, they appeared to have been considerably influential when it came to reforms regarding the regulatory framework of Germany's banking sector. The analysis has shown that reforms by and large corresponded to banks' preference for measures that facilitated the development of efficient capital markets.

How can one explain these variations in banks' political influence? In line with the argument of this study, neither institutions nor interests can fully explain these policy outcomes by themselves. Rather changing economic and political circumstances played an important role in shaping the political influence that the three banks were capable of exerting.

Clearly, interest-based explanations are by themselves not up to the task. All interviewees agreed that both issues were pursued with the same energy and intensity and yet outcomes differed substantially. In other words, there was no hierarchy of importance between the two issues that might explain why banks' preferences in one area persisted and in the other not.

Institutions, on the other hand, appear to go some distance towards explaining banks' varying political influence. With regard to regulatory issues, banks were part of a highly institutionalised policy-making network, while with regard to the issue of public sector banks no comparable network existed.

Moreover, in contrast to the pharmaceutical industry, policy-making in the financial services sector did not fit in well with the literature reviewed in Chapter 4 that diagnosed cracks in Germany's institutions. All three banks chose to work exclusively through the *Federal Association of German Banks*, and with regard to regulatory reforms, policy-making processes were neither characterised by an increasing desire on part of the government to engineer economic outcomes nor by a proliferation of organised interest groups. As a result, the policy-making network was limited to elite groups and the *FAGB* could play a privileged "insider" role in negotiations with the Ministry of Finance, the Bundesbank and the *FSBO*. As one official from the *FAGB* remarked,

"in our sector, Germany's famous decentralised decision-making structure is still very much intact, in the sense that the associations play an important role in the policy-making

process”<sup>45</sup>.

In similar vein, a *Bundestag* briefing paper has argued,

"The top officials of the regulatory agencies and the bank associations told us that they were very satisfied with how the regulatory system operated. All agreed that the relationship between the Bundesbank, the Ministry of Finance, the *FBSO* and the *FAGB* was excellent and was characterised by co-operation and collegiality. They attributed this to the fact that each agency understood its role, that legal responsibility was clearly defined and that a united front helped contain outside criticism. Finally, they noted that communication was fluid, personality conflicts rare and turf battles virtually non-existent"<sup>46</sup>.

Hence one could explain variations in banks' political influence by the differing nature of banks' institutional linkages to the policy-making process. While there may be some truth to this line of argument, it is not entirely convincing. Following the same logic one would be led to conclude that if only institutions had been more conducive, the three banks would have also succeeded in levelling the playing field between private and public sector banks. However, for reasons shown below, this is highly implausible.

In fact, both policy outcomes fit in well with this study's hypothesis that in order to adequately explain policy outcomes, interest- and institution-based explanations need to be supplemented by an analysis of the economic and political circumstances under which policy-making took place. It was argued that these circumstances were likely to have a significant impact on the preferences of the government, the opposition from other organised groups and the extent to which banks could use their internationalisation process for political leverage. Hence they could be expected to condition banks' political influence.

With regard to the issue of the public sector banks, circumstances combined in a highly unfavourable way for the three banks. First, the government was strongly in favour of maintaining the public guarantee for the state sector banks since the issue was perceived to have direct implications for employment in the sector. Despite cheaper refinancing, the public sector banks are generally regarded as less profitable than the private banks. Hence

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<sup>45</sup> Interview.

<sup>46</sup> See *FBSO* (1995). For a similar view see *FAGB* Annual Report (1998), p. 53.

withdrawing their privileges was likely to prompt a potentially nasty bout of consolidation resulting in job losses. As one interviewee put it,

"the argument that public sector banks are an inherent part of Germany's social market economy and thus deserve their public guarantee, is not more sophisticated than being afraid of losing market share. The government knows this perfectly well and is highly concerned about the implications for jobs in the banking sector"<sup>47</sup>.

Second, domestic opposition in this policy area was significant since the government was under intense pressure from the *Association of Public Sector Banks* – a highly vocal and politically well connected association. Senior politicians from Germany's *Länder*, on whose support the government often depends, often sit on their *Landesbanks'* supervisory boards<sup>48</sup>. Moreover, as one executive has remarked, "politicians also like the power a bank brings to channel cheap credit to favoured businesses"<sup>49</sup>.

Finally, banks' internationalisation process was not a source of political leverage in this policy area. After all, the "threat" to abandon domestic business in protest of the government's failure to level the playing field was hardly credible. As a result, the three banks were unable to persist with their preferences. Despite complaining for years about the competition distorting effects of the public sector banks, there was no improvement during the last decade as the government turned a blind eye to the private banks' complaints. In view of these highly unfavourable circumstances, it appears plausible to argue that even improved institutional linkages would have made little difference regarding the overall policy outcome.

With regard to reforms of the regulatory framework, matters were very different. In this policy area, the impact of circumstances on the preferences of the government, opposition from other domestic groups and banks' internationalisation process was much more favourable for the three banks. First, since the regulatory framework is neutral in its impact on employment and income distribution - obviously there is no link between, for example, increasing transparency or making easier for firms to go public and growing unemployment or a widening income distribution gap – the government's interest was limited and the issue was free from the politicisation surrounding the public sector banks.

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<sup>47</sup> Interview.

<sup>48</sup> See "Can dachshunds be whippets?", *The Economist*, Jan. 4 1997 and *Financial Times*, Oct. 22 1999.

<sup>49</sup> Interview.

Second, this state of affairs was further buttressed by the absence of organised domestic opposition. Since banking regulatory issues are of a highly technical nature, the issue did not generate much public interest. As a result, the policy-making process in this issue area remained relatively closed and the policy-making community remained confined to elite groups. Moreover, interactions were highly institutionalised and consensus-oriented (see above).

Third, banks' internationalisation process combined with the increasing integration of global capital markets gave the three banks a significant bargaining chip. As has been shown in chapter 2, a lot of banks' business in investment banking and asset management is highly mobile and can be relatively easily shifted between financial centres. As one executive noted,

"in investment banking and asset management, most business segments are very mobile. Compared with the manufacturing sector, it does not cost us very much to shift businesses between various financial centres in order to take advantage of regulatory differences"<sup>50</sup>.

In other words, the threat to shift business abroad was highly credible. Indeed, a Bundesbank official conceded that "if we want to ensure the viability of Frankfurt as a financial centre, we have little choice but to make sure that banks find the same framework conditions here as in other financial centres"<sup>51</sup>.

In view of these findings it is certainly very tempting to argue that internationalisation and lack of domestic opposition combined to give the three banks considerable political influence with regard to regulatory issues. However, one should not exaggerate this point. German regulators had an interest of their own to carry out the regulatory reforms analysed above. After all, these were not outlandish demands by banks seeking preferential treatment, but rather demands to harmonise German regulations with internationally recognised norms and standards relating to the proper and efficient functioning of capital markets. In this sense, the reforms clearly contributed to a strengthening of the German financial system. As a Bundesbank official argued,

"with the increasing integration of global capital markets it became more necessary than ever to establish international minimum standards. Our goal was to bring the German

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<sup>50</sup> Interview.

<sup>51</sup> Interview.

regulatory framework in line with international best practices”<sup>52</sup>.

In other words, while institutional linkages to the policy-making process, interests and favourable circumstances were all important explanatory factors, it is also important to note that there was a not insignificant element of congruence between the interests of the regulators and the three banks. Hence it is not entirely accurate to equate favourable policy outcomes in this issue area with political influence.

## **The Swiss Banks: Credit Suisse, Union Bank of Switzerland and Swiss Bank Corporation**

As has been pointed out in Chapter 1, the most important economic policy issues for the Swiss banks in the period from 1985 to 1995 concerned market access and regulatory issues. In contrast to Germany, public ownership of banks has not been a contentious issue in Switzerland. Hirschowicz has noted that *cantonal* banks have stuck to their traditional role of accepting deposits and granting loans in the local area and have not attracted criticism from Switzerland’s private banks<sup>53</sup>. In order to avoid repetition, the three banks’ role in the GATS Agreement for Financial Services will be analysed in Chapter 7 together with the German banks.

### **Banking Regulation**

Similar to Germany, Switzerland’s regulatory framework is essentially market conforming in the sense that banks are regulated and supervised only to ensure the safety and soundness of individual banks and of the system as a whole<sup>54</sup>. In contrast to Germany, however, Switzerland’s capital markets were by the mid-1980s already fairly developed and regulations were in general more flexible<sup>55</sup>. Däniker has observed that compared with other European countries, the process of issuing securities has always been largely deregulated in

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<sup>52</sup> Interview.

<sup>53</sup> Hirzowicz (1996), p. 10.

<sup>54</sup> For the objectives of Swiss banking regulations see Huang (1992), p. 4 and *Eidgenössisches Finanzdepartement* (1989), p. 13.

Switzerland. For example, securities did not have to be registered with any governmental or self-regulatory agency before being issued and the prospectus prepared upon issuance of securities had not been subject to prior approval by any governmental authority<sup>56</sup>.

However, this very informality was increasingly perceived as a liability instead of an asset. One interviewee noted that “prior to the major reform acts of the early 1990s, the Swiss regulatory framework was hardly conducive to promoting efficiency”. Indeed, Chapter 3 has pointed out that market-conforming regulation in financial services was not synonymous with complete deregulation. Rather, market conforming regulations aimed to safeguard the functioning of the market and protected investors by making the largest possible amount of information available to them<sup>57</sup>. Seen from this perspective, Switzerland’s regulatory framework was somewhat problematic. Schenker has argued that until recently the Swiss capital market was in a large number of areas unregulated, or in an international comparison, under-regulated. As he put it,

“Markets were not very efficient, since disclosure requirements were insufficient. Moreover, investor protection was – if at all implemented - predominantly practised through prohibitions. The *Swiss Investment Fund Act*, for example, strongly restricted fund managers’ choice of investments. Finally, shares were traded at three stock exchanges which caused a fragmentation of the market that depressed liquidity”<sup>58</sup>.

In other words, by the early 1990s the Swiss regulatory framework was far from being market conforming as a result of both too much and too little regulation.

Chapter 3 has pointed out that as a result of securitisation and banks’ internationalisation process, regulatory and supervisory issues pertaining to the efficient functioning of the Swiss capital market featured prominently on the three banks’ political agenda during the 1990s. However, Chapter 3 has also argued that the preferences of the three banks were a bit of a conundrum. Prior to 1990 they were strongly in favour of administered competition through the *Swiss Bankers’ Association (SBA)*. However, after the “big bang” in 1990 when the government abolished the conventions (see below), banks came round to accept the need for

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<sup>55</sup> See “Swiss Banks face the 1990s”, *UBS International Finance*, Winter 1991, pp. 1-8.

<sup>56</sup> See Däniker (1998), p. 58. See also “Swiss Banks face the 1990s”, *UBS International Finance*, Winter 1991, pp. 1-8.

<sup>57</sup> See for example Schenker (1996), p. 14 and Huang (1992), p. 3.

<sup>58</sup> Ibid., p. 15.

a market-conforming regulatory framework that provided for a maximum of transparency and competition<sup>59</sup>.

Similar to the German banks, the Swiss banks were well placed to exert political influence in this policy area since the Swiss regulatory structure includes both public and private actors. Switzerland's main regulatory and supervisory agency is the *Swiss Federal Banking Commission (FBC)*, which is independent of both the central bank and the Ministry of Finance. However, a number of authors have pointed out that there are usually extensive consultations between the three agencies<sup>60</sup>. Most prominent among the various banking associations is the *Swiss Bankers' Association (SBA)*, which represents, among other banks, Credit Suisse, SBC and UBS. In line with Switzerland's decentralised, "private interest" government, the SBA is, however, not merely representing the interests of its members, but also fulfils regulatory functions. For example, during the last decade the *SBA* has issued numerous guidelines for member banks in order to prevent the proliferation of formal regulations<sup>61</sup>. Examples include guidelines for risk management<sup>62</sup>, internal control<sup>63</sup> and – in conjunction with the opening of the *SOFFEX (Swiss Options and Financial Futures Exchange)* – guidelines for trade with options and financial futures<sup>64</sup>. Although self-regulation became less important during the 1990s (see below), association officials argued that the relationship with the regulators had remained very close<sup>65</sup>. In the words of one official,

"association staff are always strongly involved during the drafting stage of new policies, meetings with the FBC are usually very constructive and consensus-oriented and our concerns are generally taken seriously"<sup>66</sup>.

Turning now to policy outcomes, Hirschowicz has observed that during the 1990s Switzerland showed a hitherto seldom displayed energy for revising legislation<sup>67</sup>. During the first half of the decade, the government ratified a new law for stock exchanges and securities

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<sup>59</sup> See for example *SBA Annual Report (1990/91)*, p. 58.

<sup>60</sup> See Hirschowicz (1996), p. 189, Däniker (1998), p. 26 and Rhinow and Bayerdörfer (1990), p. 11.

<sup>61</sup> See Hirschowicz (1996), p. 454.

<sup>62</sup> See *SBA (1996b)*.

<sup>63</sup> See Thevenoz and Zulauf (1995).

<sup>64</sup> See *SBA (1990)*.

<sup>65</sup> Interviews.

<sup>66</sup> Interview.

<sup>67</sup> Hirschowicz (1996), p. 1.

trading, significantly revised the *Swiss Investment Fund Act*, and ratified a revision of the *Swiss Banking Act*.

The *Swiss Federal Act on Stock Exchanges and Securities Trading (Bundesgesetz über die Börsen und den Effektenhandel - BEHG)* was ratified in 1994, seven years after deliberations for a reform of Swiss securities laws began. The goal of the Act was threefold. First, the Act aimed to improve investor protection and efficiency through a number of measures aimed at increasing transparency. To this end, the new law replaced a number of *SBA* guidelines by formal regulations in order to ensure all market participants of fair and equal treatment and thereby promote confidence in the market<sup>68</sup>. Second, the *Act* harmonised Swiss securities regulations – prior to the *Act* exchanges and securities dealers were regulated exclusively by *cantonal* law – and extended the supervisory function of the *FBC* to include the new rules for stock exchanges<sup>69</sup>. A final objective of the *Act* was to make Switzerland's regulatory framework compatible with international regulatory standards. Hirszowicz noted that to this end, the *BEHG* incorporated several EU directives into Swiss law<sup>70</sup>.

First steps towards this law date back to October 1987, when in the aftermath of the stock market crash, the *Swiss Federal Council* commissioned an expert report on the future of the Swiss securities market. The report was published in 1989 and recommended the introduction of a federal securities law. A first proposal – presented in 1991 – provided for a substantial degree of state intervention in the activities of exchanges and securities dealers<sup>71</sup>. The *Swiss Bankers' Association* protested heavily and suggested various amendments to reduce the involvement of the government<sup>72</sup>. The *SBA*'s proposals were largely taken into consideration and the three banks broadly welcomed the final version of the *Act*. According to the *SBA*, the *BEHG* contributed significantly to the strengthening of the competitiveness of the Swiss financial centre by guaranteeing openness and increasing transparency<sup>73</sup>.

The new *Swiss Investment Fund Act (IFA)* completely revised Switzerland's main piece of investment legislation, the 1967 investment law which regulated the activities of Swiss investment funds whose management was domiciled in Switzerland and of foreign investment funds that distributed their certificates in Switzerland. Ratified in 1994, the main goal of the revision was to make Swiss legislation compatible with EU guidelines in this

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<sup>68</sup> Ibid., p. 123.

<sup>69</sup> See Däniker (1998), p. 26.

<sup>70</sup> Hirszowicz (1996), p. 210.

<sup>71</sup> See Schenker (1996), p. 100.

<sup>72</sup> See *SBA Annual Report (1991/1992)*, p. 49.

<sup>73</sup> See *SBA Annual Report (1996/97)*, p. 28.

area<sup>74</sup>. Däniker observed that the *IFA* re-enacted many provisions of EU directives relating to the regulation and supervision of collective investments in transferable securities<sup>75</sup>. Particular focus was on formalising publication requirements, which had hitherto been only informally regulated<sup>76</sup>. Hirszowicz has, however, pointed out that the *IFA* went also beyond merely incorporating EU directives in that it also provided for swift and flexible approval of new financial instruments and thereby, in effect, offered investors investment possibilities not available within the EU<sup>77</sup>.

The revision was completed in 1994 - after four years of deliberation - and the outcome largely conformed to the three banks' preferences<sup>78</sup>. One executive commented that the *IFA* "amounted to a timely and adequate law". However, the *SBA* was not successful in having all its proposals incorporated. While the provisions regarding EU compatibility, transparency and approval of new financial instruments were strongly welcomed by the *SBA*, taxation of transactions remained a problem<sup>79</sup>. Although the stamp duty and turn-over tax had been abolished for a large number of transactions during the early 1990s, they nevertheless remained in place for a few types of transactions (see below). In the eyes of the *SBA* this constituted a competitive disadvantage compared to EU countries<sup>80</sup>.

In addition to the *BEHG* and the *IFA*, the *Swiss Banking Act* – Switzerland's main piece of banking legislation – was also significantly revised. Ratified in 1994, the main goal of the revision was to ensure EU compatibility of Swiss banking laws<sup>81</sup>. Of particular importance was a provision that authorised the Swiss State to conclude treaties with other states concerning the liberalisation of trade in financial services. This revision, in effect, enabled the Swiss government to offer automatic approval of banking licenses along the lines of the EU's *Second Banking Directive* and was hence an essential pre-condition for Switzerland's participation in the GATS Agreement for Financial Services. The provision was based on a draft proposal submitted by the *SBA*<sup>82</sup>. Moreover, the revised *Banking Act* also adjusted Swiss banking legislation in a number of areas to international minimum standards proposed by the *Basle Committee*. For example, the *Act* incorporated the 1988 Basle Capital Accord

<sup>74</sup> See *SBA Annual Report* (1989/90), p. 59.

<sup>75</sup> Däniker (1998), p. 30.

<sup>76</sup> See *SBA Annual Report* (1991/92), p. 54.

<sup>77</sup> Hirszowicz (1996), p. 227.

<sup>78</sup> See *SBA Annual Report* (1993/1994), p. 59.

<sup>79</sup> See *SBA Annual Report* (1993/94), p. 59 and (1991/92), p. 55.

<sup>80</sup> See *SBA Annual Report* (1991/92), p. 55.

<sup>81</sup> See Hirszowicz (1996), p. 297 and *SBA Annual Report* (1993/1994), p. 39.

<sup>82</sup> See *SBA Annual Report* (1993/94), pp. 39f.

into Swiss law in order to adjust capital requirements to the increasing complexity of modern banking and changed risk structures<sup>83</sup>.

Apart from these major policy initiatives, there were also a number of other important measures that improved the regulatory framework. First, transaction costs were significantly reduced. Through the stamp duty (*Stempelsteuer*), Switzerland taxed until 1993 all stock and bond market transactions. From the viewpoint of the three banks, this tax constituted a grave competitive disadvantage – by the late 1980s virtually all major financial centres had abolished taxes for securities dealing and with the liberalisation of capital markets and advances in information technology, investors began to handle their transactions in the centre with the lowest costs. As a result lucrative business, like the Eurobond business and large parts of the fund management business for institutional investors, left Switzerland<sup>84</sup>. In fact, already in 1986 an IMF paper argued that Switzerland's comparatively high taxes on stock market transactions were seriously undermining the competitiveness of the Swiss financial centre<sup>85</sup>. As a result of extensive lobbying by the *SBA*, the government agreed in 1993 to abolish the stamp duty tax for a large number of transactions. The reform was, however, only a partial success as it left the stamp duty intact for some transactions, such as for example domestic bonds<sup>86</sup>. The *SBA* repeatedly complained to the Swiss government in the following years that this incomplete reform represented a not insignificant competitive disadvantage and could lead to more business leaving Switzerland<sup>87</sup>.

Second, similar to Germany, the technical infrastructure of Switzerland's financial centre improved strongly during the 1990s. By 1990, Switzerland's stock market was highly fragmented due to the existence of seven exchanges (Zurich, Basle, Geneva, Lausanne, Neuchatel and St. Gallen). In 1991, the latter four were integrated into the former three and in 1993 all of them were integrated into a new organisation called *Schweizer Börse* (Swiss Stock Exchange) domiciled in Zurich<sup>88</sup>. Since 1990 futures can be traded on the *SOFFEX* (*Swiss Options and Financial Futures Exchange*), a wholly owned subsidiary of the Swiss Stock Exchange, which offers remote membership and has alliances with the *German Futures Exchange (DTB)* and the *Chicago Board Options Exchange*. Market efficiency and liquidity

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<sup>83</sup> See Hirschowicz (1996), p. 143.

<sup>84</sup> See Schenker (1998), p. 108.

<sup>85</sup> See Christensen (1986).

<sup>86</sup> See *SBA Annual Report (1996/97)*, p. 25, *Annual Report (1993/94)*, p. 33 and Hirschowicz (1996), p. 241.

<sup>87</sup> See for example *SBA Annual Report (1996/97)*, p. 25.

<sup>88</sup> See Hirschowicz (1996), p. 485.

were likely to be further improved by the *Swiss Venture Capital Centre (SVCC)*, a market for high-risk securities issued by medium sized companies<sup>89</sup>.

### Barriers to Entry

Switzerland's banking sector is generally regarded to be open to foreign competition. Before the GATS agreement for financial services, access was granted on the basis of reciprocity and Huang has noted that there was no evidence that suggested that the reciprocity principle had been abused for protectionist purposes<sup>90</sup>. While prior to the GATS Agreement, foreign banks had to apply for a special license and had to conform with special safety requirements, these procedures were generally not considered to have been an impediment to market access<sup>91</sup>. Since the ratification of the GATS Agreements for Financial Services, access to Switzerland's financial markets is granted on the basis of MFN (see Chapter 7). In 1995, market access for foreign banks was further eased through a measure, which allowed foreign banks operating in Switzerland to use home country accounting standards (*Verordnung über ausländische Banken in der Schweiz*). *The Swiss Bankers' Association* fully supported and welcomed this initiative and was involved in the drafting of the Act<sup>92</sup>.

However, the issue of market access and three Swiss banks' liberalisation credentials were far from clear cut. As has already been pointed out in Chapter 3, the Swiss banks' attitude towards entry barriers has been somewhat ambivalent, at least prior to 1990. While the three banks have always been competing fiercely against each other in international markets, they openly colluded at home. Under the umbrella of the *Swiss Bankers' Association*, the three banks "administered" competition in the home market "in order to achieve smooth adjustment to sectoral change"<sup>93</sup>. Through several conventions, business activities were tightly regulated. From mortgage rates to TV advertisements, to the number of domestic branches each bank was allowed to operate, everything was decided by collusion rather than by arm's length competition<sup>94</sup>. The *SBA* justified these measures by arguing that limited and administered competition raised efficiency, improved transparency, led to a more robust financial system

<sup>89</sup> See Däniker (1992), pp. 18f.

<sup>90</sup> See Huang (1992), p. 79. The IMF has noted that while the principle of reciprocity was liberal in principle, it nevertheless left room for protectionism through restrictive interpretations. See IMF (1989a).

<sup>91</sup> See Huang (1992), p. 77.

<sup>92</sup> See *SBA Annual Report (1996/1997)*, p. 29.

<sup>93</sup> See *SBA Annual Report (1989/90)*, p. 73.

<sup>94</sup> See Hirschowicz (1996), p. 442. For a list of all conventions see *SBA Annual Report (1989/90)*, p. 74.

and allowed a soft adjustment process to structural change<sup>95</sup>. Citing the contestable market literature, the chief economist of the *SBA* argued that competition was not a goal in itself, but foremost an instrument to increase efficiency. What mattered was the result of competition - i.e. whether a particular market order produced competitively priced products and services and generated innovative products - and not competition itself<sup>96</sup>. In other words, critical for the analysis of a particular market order was only whether companies' success was based on superior products and innovative strategies or protection and collusion. In the case of the Swiss banks, so the *SBA*, all indicators of efficiency – i.e. return of equity, concentration and market share – showed that Switzerland's financial sector was open and efficient<sup>97</sup>.

However, with the increasing integration of international capital markets, the Swiss banking sector's unique way of conducting business became increasingly intolerable for the government and in 1986 the Swiss cartel office launched a comprehensive investigation into these practices. One interviewee remarked that

“with the increasing internationalisation in the financial services sector, foreign banks increasingly complained to the Swiss government about the somewhat unorthodox ways in which the banking sector operated”<sup>98</sup>.

During the first two years of the investigation it became relatively quickly clear that the conventions were not sustainable. Influential notables, such as the law professor Peter Böckli and the former president of the cartel office Schlüp, argued in the classical liberal tradition of Adam Smith that the purpose of framework policies could only be the promotion of spontaneous processes through which a market order evolved<sup>99</sup>. In 1989, the Swiss cartel office published the report of the 4 year long investigation into the conventions. The report strongly condemned the prevailing practices and recommended an immediate breaking up of the cartel-like structures.

This verdict drew an initially defiant response from the three banks. Through a specially established working group at the *SBA*, the three banks launched a ferocious attack on the

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<sup>95</sup> See *SBA Annual Report (1989/90)*, p. 98.

<sup>96</sup> See Blattner (1991).

<sup>97</sup> *Ibid.* See also Blattner et al. (1992). Chapter 3 has, however, noted that contestability indicators in the financial services sector were far from being unambiguous.

<sup>98</sup> Interview.

<sup>99</sup> See Böckli (1987) and Schlüp (1989).

cartel office<sup>100</sup>. Complaining that the arguments of the cartel office amounted to a glorification of competition, the three banks argued that internationalisation and the increasing integration of financial markets were sufficient to ensure the efficient functioning of the market and to prevent abuse of the conventions<sup>101</sup>. Moreover, the goal of the conventions was not monopolisation, but rather to increase efficiency and soften adjustment processes in the interest of the safety and quality of Switzerland's banks<sup>102</sup>.

However, these arguments failed to convince the government. In 1990 all conventions were declared illegal and replaced by price competition for all banking services<sup>103</sup>. One interviewee remarked that

"it was quite an extraordinary event to see the Swiss government acting so decisively against a major association [the SBA]. However, one has to recognise that the government was under strong international pressure to bring Switzerland's banking practices in line with international norms and standards"<sup>104</sup>.

As mentioned earlier, during the early 1990s, the SBA and the three banks came round to accept the need for price competition and became strong advocates of market-conforming regulatory measures, which were compatible with international norms and standards.

### **The Political Influence of Credit Suisse, Swiss Bank Corporation and Union Bank of Switzerland: An Analysis**

The reviewed policy outcomes fit somewhat uneasily with the argument of Chapter 4 that Switzerland's institutions could be expected to guide policy-making processes in the direction of compromise solutions. Clearly in the banking sector this has not been the case. The government's decision in 1990 to dismantle the conventions through which the *Swiss Bankers' Association* administered competition in the sector was an outright defeat for the three banks without any quid pro quo. Also, the policy outcomes regarding the regulatory

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<sup>100</sup> See SBA Annual Report (1989/90), p. 65. For a summary of the SBA position see Guyer (1990) and Blattner (1991)

<sup>101</sup> See SBA Annual Report (1989/90), p. 68.

<sup>102</sup> See Blattner (1991), p. 97.

<sup>103</sup> See Hirschowicz (1996), p. 66.

<sup>104</sup> Interview.

framework do not really fit the definition of compromise solutions. Similar to Germany, the Swiss reforms corresponded by and large to the three banks' preferences. However, rather than representing a refutation of the arguments made in Chapter 4, these policy outcomes are better viewed as the result of unique circumstances (see below).

The first point to make, however, is that neither institutions nor interests can adequately explain these policy outcomes by themselves. In fact, interest-based explanations are particularly inadequate: during the late 1980s, the *SBA* mounted a high profile campaign against the government and the cartel office and lost the debate, while during the first half of the 1990s, low key and discreet interest representation through the *SBA* led to policy outcomes that largely corresponded to the three banks' preferences. In other words, interest-based explanations clearly fail to explain the three banks' differing political influence across the two policy areas.

Institutions appear to be more helpful in explaining banks' varying influence. With respect to the policy outcomes that corresponded to the three banks' preferences – the regulatory reforms in the first half of the 1990s – the three banks were part of a tightly knit policy-making network. However, with regard to the banking conventions, other actors – the cartel office and the government – were involved with whom no such issue-specific policy networks existed. Hence one could explain the two policy outcomes by the degree to which institutions provided the three banks with access to the policy-making process. While there is some truth to this argument, it is, however, not entirely convincing. Inevitably, such an argument would lead to the conclusion that improved institutional linkages with regard to the conventions would have also helped the banks to obtain a more favourable policy outcome. For reasons shown below, this appears to be unlikely; in fact, just as in the German case, an analysis of the economic and political circumstances under which policy-making took place is indispensable for explaining variations in banks' political influence.

With regard to the conventions, circumstances were highly unfavourable for the three banks: first, and most importantly, the Swiss government was determined to bring Switzerland's banking regulations in line with international best practices. One interviewee observed that

"with the increasing internationalisation of financial markets, the Swiss regulatory structure came to be seen as a rather outlandish way of running a banking sector and there was increasing pressure from foreign institutions on the Swiss government to bring the

banking system in line with international norms and standards”<sup>105</sup>.

In similar vein, Hirschowicz has argued that against the background of financial liberalisation within the EU (see Chapter 7), the government began to view the banking conventions with increasing scepticism<sup>106</sup>.

Second, domestic opinion turned strongly against the banks during the late 1980s<sup>107</sup>. One interviewee noted that, “during the late 1980s the banking sector became increasingly the target of consumer groups, which were complaining about high fees and of less-than-friendly newspaper editorials that were questioning the wisdom behind restricting competition in the banking sector so drastically”<sup>108</sup>.

Finally, banks’ internationalisation process was not a source of political leverage in this policy area due to the immobile nature of banks’ domestic business. In view of these factors, it seems hardly plausible to argue that improved institutional linkages would have led to a more favourable policy outcome for the three banks.

With regard to reforms of the regulatory framework, however, circumstances were significantly more favourable for the three banks. Essentially the dynamics were the same as in the Germany. Since the issue was neutral in its effect on employment and income distribution, it remained free from the politicisation surrounding the issue of the conventions and institutions proved to be a source of political influence by providing for a relatively closed policy-making network made up of elite groups. One *SBA* official noted that

“the relatively small policy-community of technocrats made it a lot easier to reach agreements that were acceptable for all involved parties”<sup>109</sup>.

Banks’ influence was further buttressed by the mobility of much of their investment banking and asset management business, which - against the background of intensifying competition between financial centres - gave their interests considerable weight in the policy-making debate. As one executive remarked,

“as competition between financial centres began to speed up, Swiss regulators became

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<sup>105</sup> Interview.

<sup>106</sup> *Ibid.*, p. 442.

<sup>107</sup> Interviews.

<sup>108</sup> Interview.

<sup>109</sup> Interview.

increasingly keen to promote the efficiency of the financial centre in order to make it more competitive and discourage banks from shifting business abroad”<sup>110</sup>.

However, as in the German case, policy outcomes in this issue area should not necessarily be interpreted as evidence for the disproportionate political influence of banks. Like their German counterparts, Swiss regulators also had a strong interest of their own to adjust the domestic regulatory framework to international norms and standards. In fact, Schenker has observed that as a result of the increasing integration of financial markets, Swiss regulators became aware of the safety risks associated with failing to adjust domestic regulations to international best practices<sup>111</sup>. In other words, there was a not insignificant congruence between the interests of banks and regulators that makes it somewhat problematic to equate favourable policy outcomes in this issue area with political influence.

## Conclusion

The analysis has shown that in many cases policy outcomes in the German and Swiss banking sector corresponded to a significant degree to the six banks’ preferences. In fact, on balance, the six banks appeared to be more influential than the six pharmaceutical MNEs. While in both countries banks certainly suffered political defeats – in Germany, the three banks did not succeed in getting the government to level the playing field between private and public sector banks and, in Switzerland, the state abolished the conventions of the *Swiss Bankers’ Association* – the political successes were substantial. In both Germany and Switzerland, the regulatory framework underwent significant and far-reaching reforms, which largely corresponded to banks’ preferences.

With perhaps one exception, all of these policy outcomes were within the reach of the explanatory framework outlined in Chapter 1. In line with the argument of this study, it was shown that the impact of changing economic and political circumstances on the preferences of the government, the degree of opposition from other organised groups and banks’ internationalisation processes, significantly shaped the political influence that the six banks

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<sup>110</sup> Interview. For a similar view see Huang (1992), p. 19 and Hirschowicz (1996), p. 226.

<sup>111</sup> Schenker (1998), p. 15.

were capable of exerting. Similar to the situation in the pharmaceutical sector, changing circumstances went a long way towards explaining variations in banks' political influence.

The only policy outcome that did not entirely fit into this study's framework of analysis was the Swiss government's decision to abolish the conventions through which the *Swiss Bankers' Association* used to administer competition in the banking sector. There are two reasons why this policy outcome was somewhat difficult to explain. First, on the basis of Chapter 4's analysis, one would not have expected the Swiss government to take on such an active role that strongly (although only briefly) antagonised a key domestic group. It was argued that Switzerland's institutions could still be expected to guide policy-making in the direction of compromise solutions. In the case of the conventions, however, there was no quid pro quo, and the banks were the clear losers in the debate. Second, Chapters 1 and 4 have argued that government preferences centre around engineering socially desirable economic outcomes. However, clearly this desire was not behind the Swiss government's decision to abolish the banking conventions. Rather the decision was motivated by the goal of bringing Switzerland's regulatory framework in line with international norms and standards.

## MNEs' Political Influence at the European Level of Policy-Making

Chapters 5 and 6 have implicitly shown that over the last decade policy-making in a number of areas in the pharmaceutical and banking sector has shifted to the European level. Particularly significant in this context were the 1986 Single European Act (SEA) and the 1991 Maastricht Treaty, which significantly extended the scope of European policies. Hence an analysis of the political influence of German MNEs in their home country would be somewhat incomplete without also analysing their political strategies at the European level. However, the European level is also likely to matter for the Swiss MNEs. Although Switzerland is not a member, all six Swiss MNEs have substantial business operations in the EU and are thus directly affected by EU policies. Moreover, as the previous two chapters have shown, in many cases Switzerland has been “autonomously re-enacting” EU laws and regulations. Trying to influence EU policies can thus for the Swiss MNEs also be a way to shape Swiss policies.

Before turning, however, to an analysis of the 12 MNEs' political influence at the EU level of policy-making, it is worthwhile to review briefly the major arguments of the existing studies on the role of organised interest groups at the European level in order to locate this Chapter's analysis within a larger context.

Traditionally the subject was studied within the context of European integration theory. Neo-functionalism, for example, anticipated that organised groups could play a significant role in propelling integration and that they would contribute to the “spillover” of integration into other domains and sectors<sup>1</sup>. However, starting in the 1980s, the study of non-governmental groups operating at the European level became increasingly an issue in its own right. In fact, numerous studies have since then analysed the political influence that European associations or interest groups were capable of exerting and the strategies by which they were

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<sup>1</sup> See for example Haas (1958, 1964).

trying to influence European policy-making processes. The findings of these studies differ, however, considerably. While Kirchner and Schwaiger and Grant have emphasised the weakness of European associations<sup>2</sup>, Greenwood and Ronnit have shown that in certain sectors they could be very influential<sup>3</sup>. Also, while some studies have emphasised, explicitly or implicitly, the strong role of national associations with regard to interest representation at the European level<sup>4</sup>, others have emphasised the autonomous character of European interest organisations<sup>5</sup>. Similarly with regard to the nature of influence seeking, there is little agreement within the existing literature. While some studies have argued that corporatist arrangements of policy-making were absent at the European level and have put forward the “pluralist” hypothesis<sup>6</sup>, others have argued that corporatist-style relationships do exist in certain sectors<sup>7</sup>.

The following sections will now try to shed some more light on these hypotheses by applying the analytical framework used in the previous two chapters to examine the extent to which the 12 MNEs were successful in shaping policy outcomes at the EU level. Part one will provide a brief overview of the institutional structure of the European policy-making process; parts two and three will then focus on the remaining policy issues in the pharmaceutical and banking sector, analyse the extent to which policy outcomes corresponded to MNEs’ preferences, and examine whether the political influence MNEs were capable of exerting can be explained by institutions, interests or economic and political circumstances. A final part will summarise the findings and draw some cross-sector and cross-country conclusions.

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<sup>2</sup> See Kirchner and Schwaiger (1981) and Grant (1989). Particularly Grant (1990) has been very sceptical about the effectiveness and coherence of European associations, asserting that they have little significance beyond a channel of fraternal contact for members.

<sup>3</sup> See Greenwood and Ronnit (1992). See also Greenwood (1997).

<sup>4</sup> See Kirchner and Schwaiger (1981), Schmitter (1990), Streeck (1989), Kohler-Koch (1993) and Eichener (1995).

<sup>5</sup> See for example Eising and Kohler-Koch (1994), Scholz (1994), Eichener and Voelzkow (1994) and Greenwood (1997). Another strand of research has started to analyse the extent to which national systems of interest transmission were shaped by larger European developments. See Schmitter and Traxler (1994).

<sup>6</sup> See for example Streeck (1989), Schmitter (1990), Streeck and Schmitter (1991). One should, however, not over-generalise Streeck and Schmitter’s (1991) famous argument that corporatism at the European level was absent. What these authors had in mind was macro-corporatism, involving peak exchange over high politics issues between business, labour and a bureaucracy with state-like properties, whereas they had little to say about meso (sectoral) corporatism.

<sup>7</sup> See for example Greenwood and Ronnit (1992) and Greenwood (1997).

## **Institutional Structure of the EU Policy-Making Process**

Decision-making in the European Union is a complex process. From a legal point of view, all decision-making starts at the level of the Commission, where policy proposals are formulated by one, or more, of the twenty-three Directorates-Generales (DG). After adoption by the Commission, proposals are then passed to the so-called representative bodies: the European Parliament (EP), the Economic and Social Committee (ESC or Ecosoc) and, since the Maastricht Treaty, the Regional Committee (RC). While the latter two bodies are purely advisory, the EP possesses a variety of powers, depending on the decision-making procedure: only advisory in the “consultation procedure”, with potentially effective power of amendment in the “co-operation procedure” and with veto-power in the “co-decision procedure”. Proposals and responses from the representative bodies then come together at the Committee of Permanent Representatives (Coreper), the lowest level of the Council of Ministers (CM). An agreement in the Coreper is automatically accepted in the CM. If no agreement is reached, negotiations shift to the related Council, or the higher level of Ministers of Foreign Affairs and, in the last resort, to the European Council (heads of state). Under the consultation procedure, the CM decides by unanimity and under two other procedures usually by qualified majority voting. Directly binding decisions (regulations and decrees) are implemented by the Commission, whereas indirectly binding ones (directives) are passed to the national governments for implementation. The European Court of Justice (ECJ) adjudicates and may settle conflicts<sup>8</sup>.

As a result of this complex decision-making structure, there are various points of access for interest groups seeking to participate in European public affairs. Of particular importance, however, is the European Commission. Although its powers have been somewhat eroded in recent years<sup>9</sup>, Commission officials preparing draft proposals remain the natural focus of interest groups seeking to influence the content of European policies<sup>10</sup>. Greenwood has argued that “the role of the Commission as the responsible agency for drafting legislation makes it the foremost institutional target for interest representation at the European level because it is in the early stages of initiatives that most influence can be exerted”<sup>11</sup>. In similar vein, Pedler and Van Schendelen have noted that “the Commission functions as a normal

<sup>8</sup> For a detailed description of the EU’s policy making system see Pedler and Van Schendelen (1994), pp. 10ff.

<sup>9</sup> Since the Maastricht Treaty, the European Parliament and the Council of Ministers can ask the Commission under articles 152 (for the Council) and 138b (for the Parliament) to bring forward proposals.

<sup>10</sup> See Mazey and Richardson (1993), p. 10.

<sup>11</sup> Greenwood (1997), p. 27.

bureaucracy, in the sense that most of its proposals are substantially accepted: it casts the die of decision-making”<sup>12</sup>.

Moreover, the Commission is generally regarded to be relatively open to interest groups and often even depends on outside policy input<sup>13</sup>. Greenwood has pointed out that the “European Commission is so small that there might be just one official with responsibility for the affairs of an entire business domain.....It has therefore become dependent upon input from specialist outside interests, sometimes to the extent that European business interest groups write Commission reports”<sup>14</sup>. Indeed, a recent report from the Commission recorded in its opening paragraph that

“The Commission has always been an institution open to outside input. The Commission believes this process to be fundamental to the development of its policies. This dialogue has proved valuable to both the Commission and to interested outside parties. Commission officials acknowledge the need for such outside input and welcome it”<sup>15</sup>.

External views can find their way into European policies principally through two types of advisory committees: expert committees and consultative committees, which total roughly a thousand in number. Expert committees consist of national officials and experts, whereas the second type, the consultative committees, involve sectional interests drawn from European-level aggregations of interests<sup>16</sup>. Although single-firm representations to the Commission are heard, the firm concerned is usually told that the Commission would wish to explore the issue further by talking to the interest group concerned in order to ensure that it gets a more representative opinion<sup>17</sup>.

Second in importance as an institutional target for interest representation is the European Parliament. Although the EP has since 1986 become a somewhat more influential actor, its influence arises principally from its right to amend certain pieces of legislation under the so-called “co-operation” procedure<sup>18</sup>. Bognata has argued that the practical effect of the co-

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<sup>12</sup> Peddler and Van Schendelen (1994), p. 12.

<sup>13</sup> Ibid., p. 14.

<sup>14</sup> Greenwood (1997), pp. 1f.

<sup>15</sup> See European Commission (1992c), p. 3.

<sup>16</sup> See Greenwood (1997), p. 41.

<sup>17</sup> Ibid.

<sup>18</sup> Ibid., p. 27. Prior to the SEA the EP had no legislative powers and the Council of Ministers was under no obligation to take the views of MEPs into account. Since 1986, however, the European parliament has become a somewhat more influential actor. In an attempt to redress the so-called “democratic deficit” within the EC, the SEA introduced a new “co-operation procedure” which grants the EP the right to a second reading of all

operation procedure has been to draw the parliament into the early stages of policy-making, so that compromises can already be negotiated in the first reading stage. For interest groups the EP has thus become a useful means to amend EU legislation<sup>19</sup>. However, Mazey and Richardson have argued that usually only interest groups which lack the resources to sustain continuous contact with Commission officials on technical matters centre their lobbying efforts at the EP<sup>20</sup>. Particularly environmental groups view the parliament as a very useful forum. Greenwood has argued that all environmental NGOs have a natural ally in the European Parliament, whose members are quick to take up concerns popular with their electorate. Producer groups, on the other hand, normally see the EP as very much a secondary arena for lobbying purposes<sup>21</sup>.

Finally, in third place as a target for interest representation is the Council of Ministers. Although being the most powerful decision-maker in the EU, the Council is generally not considered to be a natural institution for interest representation by non-governmental groups. In contrast to the Commission and the Parliament, which are “European bodies”, the Council is an intergovernmental body where national officials and ministers seek to secure the best possible deal for their government. The fact that the meetings are secret and closed - and that interest groups have no direct access to it - has limited the degree to which lobbying is feasible<sup>22</sup>. Moreover, Greenwood has argued that at this late stage in the decision-making cycle, it becomes more difficult to exert influence because policies have already been shaped, and interventions may require seeking changes to entrenched positions<sup>23</sup>.

As the scope of policies decided at the European level has been steadily increasing during the last decade, so too has the number of organised interest groups. In 1992 the Commission estimated that there were some 3000 interest groups in Brussels seeking to exert influence on European public affairs<sup>24</sup>. However, it is often argued that industry groups have traditionally dominated European-level interest representation - partly because of the history of the EU as an economic community<sup>25</sup>, and partly because they have more of the resources which public authorities need, i.e. information and expertise, economic muscle, status and power in

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Community legislation relating to the establishment and functioning of the internal market, social and economic cohesion, technological research and development and certain aspects of EC social and regional policies. See Mazey and Richardson (1993), p. 11.

<sup>19</sup> See Bognata (1989).

<sup>20</sup> Mazey and Richardson (1993), p. 12.

<sup>21</sup> See Greenwood (1997), pp. 43, 191.

<sup>22</sup> See Mazey and Richardson (1993), p. 14.

<sup>23</sup> See Greenwood (1997), p. 27.

<sup>24</sup> See European Commission (1992c).

<sup>25</sup> Greenwood (1997), p. 101.

implementation<sup>26</sup>. Organised business interests range from large, cross sectoral federations like UNICE (Union of Industrial and Employers' Confederations of Europe), EUROCHAMRES (the Association of Chambers of Commerce and Industry), the ERT (the European Round Table of Industrialists) and the AMCHAM-EU (the EU Committee of the American Chamber of Commerce) to networks as informal as lunch clubs.

However, in recent years, other, non-business interest organisations have also been proliferating<sup>27</sup>. Of particular importance have been environmental organisations, which discovered the European level during the late 1980s, as the European Commission became increasingly active in environmental policy-making<sup>28</sup>. The scope of environmental policy has since then grown steadily, comprising hundreds of directives and numerous environmental action programmes<sup>29</sup>. Young has pointed out that the number of environmental directives in the period from 1989 to 1991 exceeded those of the preceding twenty years<sup>30</sup>. During the period from 1986 to 1992, staff at DG XI (Environment) grew from 55 to 450<sup>31</sup>. By the early 1990s there were about 150 environmental organisations active at the EU level, which were loosely grouped together by the European Environmental Bureau. In addition there are also environmental pressure groups, which form part of a wider environmental movement, which also includes political parties and other organisations with a direct interest in environmental policy, such as for example consumer protection groups<sup>32</sup>.

## **The Six German and Swiss Pharmaceutical MNEs**

Chapter 5 has pointed out that policy-making at the European level has been of relevance for the six pharmaceutical MNEs with regard to biotechnology regulations and intellectual property rights. A further issue during the early 1990s concerned a planned directive for the regulation of industries' marketing activities.

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<sup>26</sup> Ibid., pp. 16-20.

<sup>27</sup> Mazey and Richardson (1993), pp. 3f.

<sup>28</sup> Although environmental policy was not mentioned in the original treaty, Community action was taken first on the ground that national measures could act as trade barriers and disrupt the functioning of the Common Market, and second because environmental problems were of such a scale that they required a co-ordinated response. Community powers were enshrined in the 1986 Single European Act (SEA) and subsequently expanded in the Maastricht Treaty. See Hildebrand (1993).

<sup>29</sup> See Collier and Golub (1997), p. 236. The EU has adopted directives on eco-audits, energy efficiency and eco-labels, and is considering framework legislation on eco-taxes. See Collier and Golub (1997), p. 242.

<sup>30</sup> See Young (1995).

<sup>31</sup> See Weale and Williams (1994).

<sup>32</sup> See Grant (1993), p. 42 and Greenwood (1997), p. 191.

Although the European Commission made tentative efforts to promote R&D co-operation, as it had in the electronics sector<sup>33</sup>, the six MNEs showed little interest in such policies. For example, none of them participated in the BRIDGE biotechnology research programme (Biotechnology Research for Innovation, Development and Growth in Europe) that the Commission initiated in 1990<sup>34</sup>. Instead, the focus of the six MNEs was very clearly on improving framework conditions regarding biotechnology regulations and intellectual property rights, and making sure that the Commission did not get involved in the marketing practices of the industry. The following sections will now analyse the extent to which policy outcomes in these three issue areas corresponded to the six MNEs preferences and how one can explain the influence they were capable of exerting.

### **Biotechnology Regulation**

With regard to biotechnology regulations, two sets of issues need to be analysed: regulations for the approval of production facilities and research projects, and regulations pertaining to the approval of drugs.

#### **Approval of Production Facilities and Research Projects**

With respect to the regulation of production facilities and research projects, the European Commission issued a number of directives to create a European minimum standard. The first two directives (90/219 and 90/220) were issued in 1990 and prescribed a relatively high safety level. Bandelow, for example, has pointed out that they prohibited a number of experiments, which were in the US already since 1981 exempted from regulation<sup>35</sup>. Moreover, the six MNEs complained that both directives did not correspond to their preference for transparency and predictability<sup>36</sup>. As one executive put it,

"essentially these two directives left national governments plenty of scope to set up a very strict regulatory regime that legitimised unpredictability, legal uncertainty and plenty of

<sup>33</sup> See van Tulder and Junne (1988) and Peterson (1993).

<sup>34</sup> See Bongert (1997), p. 128.

<sup>35</sup> Bandelow (1999), pp. 105f.

red tape. In the case of Germany, this has been clearly visible"<sup>37</sup>.

This negative policy outcome was somewhat surprising, since the main background work for the two directives took place in a relatively industry-friendly climate during the mid-1980s. Motivated by a desire to promote both the European integration process and the nascent European biotechnology industry, the Commission laid down a first framework for planned safety measures in 1986. This framework was based on a jointly drafted proposal by DG III (Single Market and Industry Issues), VI (Agriculture), XI (Environment and Consumer Protection) and XII (Science and Technology) and leading experts from member countries<sup>38</sup>. A number of authors have argued that at this early stage, the pro biotechnology lobby within the Commission clearly dominated the debate and that the Commission saw its main task in promoting the development and application of biotechnology<sup>39</sup>. An important factor behind this positive attitude was that the project was under the supervision of DG III – traditionally an industry-friendly Directorate-General – which was between 1985 and 1988 headed by the German Commissioner Narjes, a clear advocate of biotechnology<sup>40</sup>. Moreover, it has been noted that environmental and consumer protection groups played only a negligible role during this period<sup>41</sup>.

However, in the run-up to the final formulation of the two directives, this favourable environment changed rapidly as a result of several developments. First, supervision over the directives was transferred to the less industry-friendly DG XI (Environment and Consumer Protection) since DG III was suffering from a heavy workload during the late 1980s. Bandelow has argued that this strongly shifted the emphasis from industry concerns to environmental concerns<sup>42</sup>. Second, in 1987 the Commission obtained formal regulatory powers for a common environmental policy<sup>43</sup>. This led to increased lobbying activities from environmental groups, which were strongly opposed to biotechnology and advocated strict and comprehensive regulations<sup>44</sup>. Finally, industry's interest representation activities in this

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<sup>36</sup> Interviews.

<sup>37</sup> Interview.

<sup>38</sup> See OECD (1986) and Gottweis (1995) pp. 430-432.

<sup>39</sup> See for example Greenwood and Ronnit (1992), p. 92 and Bandelow (1999), p. 99.

<sup>40</sup> See Narjes (1986).

<sup>41</sup> See for example Bandelow (1999), p. 99.

<sup>42</sup> Ibid., p. 156.

<sup>43</sup> See footnote 21.

<sup>44</sup> See Bandelow (1999), p.165.

policy area were by the late 1980s highly ineffective<sup>45</sup>. Greenwood has noted that interest representation in this issue area was by the late 1980s at best patchy across member states – some of the national biotechnology associations were only formed as recently as 1990 - and hence there was no well-organised and coherent European lobbying<sup>46</sup>. Moreover, a number of studies have pointed out that the European pharmaceutical industry underestimated the significance of the two directives<sup>47</sup>.

With defeat looming, the European pharmaceutical industry finally reacted in 1989 when a number of MNEs, including Hoechst and Sandoz<sup>48</sup>, set up the *Senior Advisory Group Biotechnology (SAGB)*. By 1994, the *SAGB* had 30 members including the six MNEs selected for this study. Operationally headed by a former Commission official from DG XII, the *SAGB* became during the 1990s an effective instrument for the articulation of the European pharmaceutical industry's concerns<sup>49</sup>. Although it appeared too late on the stage to have an impact on directives 90/219 and 90/220, the *SAGB* was during the following years considerably successful with its efforts to improve the regulatory environment for biotechnology. Bandelow and Greenwood have observed that in 1991, the *SAGB* was instrumental for the establishment of a *Biotechnology Co-ordination Group* comprising DG III, VI, XI and XII<sup>50</sup>. A number of authors have argued that the practical effect of this group was to dilute the influence of DG XI and to promote the concerns of the pharmaceutical industry<sup>51</sup>. In fact, in the same year the Commission announced a review of guidelines 90/219 and 90/220 and involved the *SAGB* in the drafting of a comprehensive revision that centred on the de-bureaucratisation and streamlining of approval procedures<sup>52</sup>. The ratification of these proposals turned out to be difficult, however, since Germany was the only country that experienced highly negative consequences from directives 90/219 and 90/220; other European countries implemented much more pragmatically<sup>53</sup>. However, despite these delays, the regulatory framework for biotechnology was further eased during the mid-90s. In 1994,

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<sup>45</sup> During the late 1980s, industry representation for biotechnology issues was carried out by the *European Biotechnology Co-ordinating Group (EBCG)* – a loose grouping of national associations without a permanent secretariat.

<sup>46</sup> See Greenwood (1994), pp. 190f.

<sup>47</sup> See for example Greenwood (1995, 1997) and Greenwood and Ronnit (1992a, 1994).

<sup>48</sup> The other MNEs were ICI, Monsanto, Unilever, Rhone-Poulenc and Ferruzzi

<sup>49</sup> See Greenwood (1994), p. 193 and Bandelow (1999), p. 135.

<sup>50</sup> Bandelow (1999), p. 135 and Greenwood (1994), p. 194.

<sup>51</sup> See Gottweis (1995), p. 247, Dolata (1996), pp. 63f., Szczepanik (1993), p. 630 and Greenwood and Ronnit (1992), p. 92.

<sup>52</sup> See Bandelow (1999), pp. 134ff. and Wheale and McNally (1993), p. 262.

<sup>53</sup> See Bandelow (1999), p. 135.

the Commission issued three directives, which lowered safety requirements and broadened the definition of the term “research purpose”<sup>54</sup>.

## Approval Procedures for Biotechnology-Based Products

During the 1980s and 1990s the European Commission began to extend its regulatory powers to the approval of drugs and, particularly, to drugs involving biotechnology. First steps occurred in 1973 when directive 73/319 established the *Committee for Proprietary Medicinal Products (CPMP)* to oversee a system of partial mutual recognition of approval authorisations granted by one member state to some, or all other member states. Initially slow and cumbersome in its decision-making, the committee improved its decision-making procedures continually during the 1980s and early 1990s. Improvements included direct company representation on the *CPMP* and the introduction of an accelerated scheme for high technology products<sup>55</sup>. Greenwood and Ronnit have argued that these changes were the result of complaints from the *EFPIA (European Federation of Pharmaceutical Industries’ Association)*, which was established in 1978 as the European association of national associations to ensure that “the conditions relating to the supply of medicines are appropriate to the production and development of medicines”<sup>56</sup>.

The increasing centralisation of drug approval procedures culminated in 1995 with the establishment of the London-based *European Medicines Evaluation Agency (EMEA)*. Its centralised procedure is mandatory for biotechnology products and optional for other new medicines. Once a product has been approved by the *EMEA*, it can then be put on the market in all member states of the Union. The Boston Consulting Group has noted that this has made it easier for new products to gain access to the European market and reduced the time needed for regulatory approval<sup>57</sup>.

All six MNEs strongly supported the centralisation of drug approval procedures, not least since they saw it as a means to bypass slow and unpredictable procedures at home<sup>58</sup>. Through

<sup>54</sup> See Directives 94/15, 94/730 and 94/211. See also Bandelow (1999), pp. 161f.

<sup>55</sup> See Greenwood and Ronnit (1992), p. 82.

<sup>56</sup> Ibid. See also EFPIA (1988), p. 16.

<sup>57</sup> Boston Consulting Group (1995), p. 65.

<sup>58</sup> Hoffmeyer has pointed out that during the late 1980s and early 1990s – when the German Health Office (*Bundesgesundheitsamt*) was primarily in charge of drug approval – there was a backlog of approval admissions and the average approval period took several years. See Hoffmeyer (1993), para 6.3.6.5. Chapter 5 noted that Swiss approval procedures were also far from ideal for the three MNEs, although they steadily improved during the 1990s. See Hoffmeyer (1993), para 6.3.6.5.

the *EFPIA*, they strongly lobbied for a centralised European agency, preferably in a biotechnology-friendly country. In this sense, the establishment of the *EMEA* in the UK – then considered to have been a biotechnology-friendly country – strongly corresponded to the six MNEs' preferences and represented a considerable political success<sup>59</sup>. One executive commented that “the establishment of the *EMEA* in London was perceived at the time as a very constructive development”<sup>60</sup>.

However, it must be said that the *EMEA* has been far from an ideal regulatory body from the six MNEs' viewpoint. Chapter 3 has argued that the six MNEs strongly favoured a regulatory regime that was based on scientific principles and that treated biotechnology like any other existing technology. Through the *EFPIA*, all six MNEs have been strongly arguing for an independent regulatory authority that – similar to the *FDA* in the US – regulated products derived from the application of biotechnology under existing, product-based regulations, regardless of the methods by which they were produced<sup>61</sup>. In other words, regulatory control should not revolve around the fact that an organism had been modified by any particular technique since, from the point of view of the six MNEs, this fact alone was not a sufficient indication of risk<sup>62</sup>. However, this principle has been flouted by the *EMEA* since the agencies' regulations reflect the view that all recombinant DNA techniques require oversight and controls that are specifically designed for rDNA operations<sup>63</sup>. Rather than treating biotechnology like any other existing technology, European regulations were based on the view that biotechnology was distinct from conventional technologies and thus required biotechnology-specific, process-based regulations<sup>64</sup>. As two scientists from Bayer and Hoechst have argued,

"There have been continuous statements, particularly from the European Commission, that the European system is equivalent to the US regulatory system without considering the fundamental difference of both regulatory systems – product-based in the US versus technology-based regulations in the EU"<sup>65</sup>.

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<sup>59</sup> Interviews.

<sup>60</sup> Interview.

<sup>61</sup> For the design of US regulations see Office of Science and Technology Police (1986).

<sup>62</sup> The US National Research Council (1989) has extensively reviewed the potential risks of introducing genetically modified organisms into the environment. It reached the general conclusion that organisms that have been genetically modified are not per se of inherently greater risk than unmodified organisms.

<sup>63</sup> See Bauer and Schlumberger (1994).

<sup>64</sup> See Boston Consulting Group (1995), p. 64.

<sup>65</sup> See Bauer and Schlumberger (1994), p. 1.

The practical implication of this difference has been that once a product has been sent for approval to the *EMEA*, the final decision is based on politics rather than science – something, which has created considerable uncertainties regarding the final outcome<sup>66</sup>. The Boston Consulting Group has noted that

“the European approach of letting a standing committee of representatives of the member states decide whether a product can be marketed has led to decisions being taken on non-scientific grounds, particularly in the agricultural and food sectors; it has also led to significant delays in the approval of products”<sup>67</sup>.

The implications of the EU’s approval system for biotechnology-based products reach, however, beyond creating difficulties for individual companies. In fact, Europe’s approval procedures are a prime example of how the design of national regulatory frameworks can lead to international trade conflicts. During the second half of the 1990s, the US - as a major exporter of genetically modified agricultural products – has been increasingly complaining that the extensive involvement of politicians in the European approval process for products derived from the application of biotechnology clash with WTO rules that require decisions based on sound science<sup>68</sup>.

### **Intellectual Property Rights**

Chapter 3 has pointed out that the protection of intellectual property was of critical importance for the six pharmaceutical MNEs. Despite the existence of national patent laws, both the German and the Swiss MNEs considered this issue-area to be a “European” one and centred their political activities at the European level of policy-making. This has mainly to do with European patent laws; a European agreement of 1963 established the foundations for Europe-wide patent laws. The European Patent Convention of 1973 built on this foundation and led to the establishment of the European Patent Organisation, which grants patents that are valid throughout the EU. Despite not being a member of the EU, Switzerland has always

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<sup>66</sup> See Boston Consulting Group (1995), p. 63.

<sup>67</sup> Ibid., p. 64.

<sup>68</sup> See for example Stuart Eizenstat “Why we should welcome biotechnology”, *Financial Times*, April 16 1999. See Chapter 3, footnote 2.

participated in attempts to establish Europe-wide patent laws and is a member of the European Patent Organisation<sup>69</sup>.

With regard to intellectual property rights, three sets of issues need to be considered: the TRIPS Agreement, negotiated within the context of the Uruguay Round, a directive clarifying the patentability of biotechnological inventions and, finally, the more technical issues of grace periods and patent restoration terms.

### **TRIPS (Trade Related Aspects of Intellectual Property Rights)**

The TRIPS Agreement of the Uruguay Round was an attempt to establish global minimum standards for the protection of intellectual property and to bring disputes within the dispute settlement mechanism of the WTO. All six MNEs were strongly in favour of this US-led initiative. As Hoechst's deputy general counsel for patents has argued,

"The immense costs of R&D can be recovered only if there is a limited but reasonable period of patent protection. Thus far, many countries have insufficient patent laws with no protection for new products, with the consequence that local companies make use of the most successful inventions made in other countries by counterfeiting and without investing in R&D. The TRIPS Agreement will improve this situation"<sup>70</sup>.

Before the conclusion of the TRIPS agreement, the international legal framework for the protection of intellectual property consisted of a patchwork of treaties. These were administered by, and negotiated under, the auspices of the World Intellectual Property Organisation (WIPO), which aimed to protect intellectual property rights at the international level through agreed minimum standards<sup>71</sup>. The most important international treaty concerning the protection of industrial property before the TRIPS was the Paris Convention on the Protection of Industrial Property of 1883, as amended from time to time and, in particular, in Stockholm in 1967. Although this regime went a considerable way towards providing a workable international system for intellectual property rights, there were several

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<sup>69</sup> See Büchel and Braucbar (1997), p. 28.

<sup>70</sup> Schulze-Steinen (1996), p. 52.

<sup>71</sup> The principal WIPO treaties are the Paris Convention (industrial property), the Berne Convention (copyright), the Rome Convention (neighbouring rights, jointly administered by WIPO, UNESCO and ILO) and the Washington Treaty (integrated circuits). For an overview see Yong d'Herve (1996), p. 8.

problems – most importantly the absence of enforcement and dispute settlement mechanisms<sup>72</sup>. The TRIPS was intended to make up for these shortcomings. Designed to complement and operate in harmony with existing WIPO-administered international conventions, the agreement defined minimum standards, which WTO member states had to incorporate into domestic law and provided international dispute settlement provisions<sup>73</sup>. Fink and Primo Braga have noted that the TRIPS agreement represented the so far most far-reaching multilateral agreement towards global harmonisation of intellectual property rights<sup>74</sup>.

From the viewpoint of the six MNEs, the TRIPS agreement was, however, only a qualified success. While the agreement certainly improved worldwide protection of intellectual property rights<sup>75</sup>, there were also significant drawbacks. Article 27 recognised a number of very broad exclusions that, in the opinion of *Interpharma*, could be understood not only to allow the exclusion of certain pharmaceutical products and processes from patentability, but which also substantially limited protection for products derived from biotechnology<sup>76</sup>. Moreover, definitions in general were vague. Schulze-Steinen has noted that “the terms ‘shall’ and ‘may’ were carefully used”<sup>77</sup>. Moreover, the six MNEs strongly criticised the lack of pipeline protection in the TRIPS<sup>78</sup>. Pipeline protection would have required nations providing patent protection for drugs for the first time to extend this protection to such products already patented in other nations for the remainder of their patent terms. Finally, the TRIPS agreement granted developing countries transition periods – either 5 or 10 years – which the industry considered too long<sup>79</sup>. Nevertheless both *Interpharma* and the VFA considered the TRIPs Agreement an important first step in obtaining effective international intellectual property protection. Schulze-Steinen noted that even if the present TRIPS

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<sup>72</sup> See Yong-d’Herve (1996), p. 9.

<sup>73</sup> *Ibid.*

<sup>74</sup> Fink and Prima Braga (1999), p.1. For a detailed evaluation of the TRIPs Agreement see Primo Braga (1996).

<sup>75</sup> The patent section of the TRIPs provides a twenty year term of protection from time of filing and defines patentable subject matter as any invention, whether product or process, that is new, involves an inventive step, and is capable of industrial application. The agreement further strengthens the patent right by prohibiting patent discrimination based on the place of invention, the field of technology or whether the product is imported or domestically produced. Doane (1996, p. 479) has argued that this represents a significant step towards establishing basic patent standards in international law. Moreover, the TRIPs made some progress towards the international harmonisation of patent procedures. For example, the US system is based on a first-to-invent filing system rather than the first-to-file process in Europe and elsewhere. Under the US system, priority is granted on the basis of proof of invention. Until the TRIPs agreement, foreign inventors could not submit evidence of priority of invention in interference proceedings in the US. Now they are eligible to do so. See EuropaBio (1997), p. 66.

<sup>76</sup> See Büchel and Brauchbar (1997), p. 16.

<sup>77</sup> Schulze-Steinen (1996), p. 47.

<sup>78</sup> Interviews. See also Doane (1996), p. 479.

<sup>79</sup> Interviews. See also VFA Annual Report (1996), p. 16 and Büchel and Brauchbar (1997), p. 16.

Agreement was not perfect and complete, it was a basis for further harmonising laws, legal decisions and regulations<sup>80</sup>.

The role of the six MNEs in the negotiating process of the TRIPS was, however, a bit of a conundrum. Despite the importance of this agreement for the six MNEs, the *EFPIA*, as well as the German and Swiss national associations, were largely uninvolved in the negotiating process. A number of authors have pointed out that right from the beginning the US government and the US business community were the driving forces for getting the TRIPs on the agenda of the Uruguay Round and for pushing it through against the resistance of developing countries, which by and large believed that worldwide harmonisation of intellectual property protection exceeded the GATT's mandate and would only widen the gap between industrialised and developing countries<sup>81</sup>.

Saylor and Beton have argued that since the US had the largest high-tech sector among industrialised countries, it was only natural that the US was the first country to recognise the increasing importance of intellectual property rights<sup>82</sup>. In fact, a study by the US International Trade Commission estimated that in 1986 worldwide losses to US industry from inadequate protection of intellectual property ranged from \$43bn to \$61bn<sup>83</sup>. As a response, the US evoked during the 1980s and early 1990s a "get tough" policy against unfair foreign competition that, according to a number of authors, significantly contributed towards overcoming developing nation's resistance to include intellectual property rights in the Uruguay Round<sup>84</sup>. Moreover, the US business community was right from the start highly supportive of the US governments' policy. Doane has noted that when the issue was on the agenda of the Uruguay Round, the US business community was instrumental in pushing it through, by, for example, offering inducements to developing countries<sup>85</sup>. In contrast, the major industrial umbrella organisation in Europe (UNICE) was, at least initially, more sceptical about including intellectual property rights into an international trade regime that

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<sup>80</sup> Schulze-Steinen (1996), p. 53.

<sup>81</sup> See Doane (1996), p. 467 and Saylor and Beton (1996), p. 15. See also "Bio-piracy under new fire", *Financial Times*, November 30 1993.

<sup>82</sup> Saylor and Beton (1996), p. 12. See also Doane (1996), p. 465 and Fink and Primo Braga (1999).

<sup>83</sup> Quoted in Saylor and Beton (1996), p. 12.

<sup>84</sup> See Doane (1996), p. 472. In 1984 Congress passed trade legislation which contained several provisions on intellectual property, basically making US market access and preferential trade arrangements subject to effective intellectual property protection by foreign countries. See Saylor and Beton (1996), p. 13. Measures included the instigation of Section 301 actions against nations with inadequate protection of intellectual property – particularly Taiwan, Thailand and South Korea - and the use of Section 337 of the Tariff Act of 1930, which allows the seizure and destruction of infringed goods at the US border. During this period, South Korea, Mexico, Brazil and Thailand had their tariff concessions extended to them under the Generalised System Preferences withdrawn. See Doane (1996), p. 468. For a more detailed analysis of US unilateralism during this period see Trebilcock and Howse (1999), pp. 317-319.

had historically focused on traditional impediments to manufactured products<sup>86</sup>. However, these concerns vanished when in 1988 the *Intellectual Property Committee (IPC)* - a forum representing US industry – presented a detailed draft for an agreement for the international protection of intellectual property. The draft was well received by the European (and Japanese) business community and became the basis for a unified trilateral view on what a TRIPS Agreement should contain<sup>87</sup>. Saylor and Beton observed that, in the end, the TRIPS agreement provided minimum standards, which closely matched the initial proposal of the US<sup>88</sup>.

### **Intellectual Property Rights and Biotechnology Inventions**

The issue of whether patents can be extended to biological inventions was a source of great controversy during the 1990s. Chapter 2 has pointed out that rapid advances in decoding the strings of letters, or nucleotides, that determine a gene's function were helping scientists to make the transition from merely describing a disease to understanding its mechanism. This could open up a new class of drugs with wide commercial applications. The question that remained, however, was who should own the genetic information underpinning this scientific discovery. For the six pharmaceutical MNEs the case was straightforward. All six firms argued that genes should not be treated differently than other inventions, meaning that if a process was novel and had "utility" it should be possible to obtain a patent. Counteracting the populist claim that a patent on a gene was somehow a patent on life itself, one interviewee noted,

"Nobody owns the genes in people, but if I invent a use for a certain gene, I can own that process for 20 years. It is quite routine and ordinary. In other words, the critique of 'no-patents on life' misses the point. Biotechnological inventions can only be patented because the invention which is embodied in a living organism is new and invented and does not occur in this form in nature"<sup>89</sup>.

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<sup>85</sup> See Doane (1996), p. 478.

<sup>86</sup> See Saylor and Beton (1996), p. 14.

<sup>87</sup> See Doane (1996), pp. 473f. For a similar view see Saylor and Beton (1996), p. 14.

<sup>88</sup> See Saylor and Beton (1996), p. 14.

<sup>89</sup> Interview.

Moreover, all six MNEs argued that extending patent protection to biotechnology inventions was of critical importance since without it, the incentive to innovate was undermined<sup>90</sup>.

Turning now to policy outcomes, the main policy issue in this area centred on the interpretation of European patent laws. While the six MNEs generally regarded European patent laws as adequate, they complained about uncertainties regarding their applicability to biotechnology inventions<sup>91</sup>. One interviewee explained that

“when the rules for patent protection were laid down, developments in modern biotechnology could not be foreseen. As a result, the application of patent law in this area is new legal territory for patent authorities and courts in the EU, with the result that there is uncertainty whether patents can be obtained on biotechnological inventions”<sup>92</sup>.

*Interpharma* has pointed out that there was no consensus among national patent authorities and the *EPO* regarding the patenting of biotechnology inventions<sup>93</sup>. Although the *EPO* has granted several hundred of biotechnology patents, public opposition and delays have fostered a general sense of uncertainty among companies<sup>94</sup>. This situation contrasts sharply with that in the US. Although there is little perceived difference between European and US patent protection, it is widely held that the US provides a more secure intellectual property environment. A number of studies have pointed out that the US has led the way in developing legal precedents to protect biotechnology inventions and has been generous in upholding biotechnology patents, which were diverse in nature and very broad in scope. Key decisions by US courts signalled to industry that it could expect strong and wide-ranging protection for new biotechnology products and processes<sup>95</sup>.

Keen to improve the situation and to catch-up with the US, the European Commission took up the issue in the late 1980s and began drafting a directive that was supposed to clarify the interpretation of existing patent laws by defining how narrow the criteria had to be interpreted so that patents on biotechnology inventions could be granted<sup>96</sup>. The European pharmaceutical industry strongly supported this initiative and both the *EFPIA* and the *SAGB*

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<sup>90</sup> See for example *EuropaBio* (1997), p. 65, *Humer* (1997), p. 83 and *VFA* (1997).

<sup>91</sup> Interviews. See also *Büchel* and *Brauchbar* (1997), pp. 28f.

<sup>92</sup> Interview.

<sup>93</sup> See *Büchel* and *Brauchbar* (1997), p. 39.

<sup>94</sup> See *EuropaBio* (1997), p. 67.

<sup>95</sup> See *EuropaBio* (1997), p. 67 and US Congress, Government Office of Technology Assessment (1991).

<sup>96</sup> See *EuroaBio* (1997), p. 12.

were strongly involved in the drafting stage<sup>97</sup>. Greenwood has called the directive a “purely industry-inspired initiative”<sup>98</sup>. After seven years of deliberation, the Commission presented a draft directive in 1995. From the industry’s point of view, the outcome represented an acceptable compromise and both the *VFA* and *Interpharma* advocated quick enactment<sup>99</sup>. In the spring of 1995, the draft was, however, rejected by the European Parliament. All interviewees were unanimous that this political defeat could be squarely attributed to the activities of environmental interest groups, which succeeded in politicising the issue to such an extent that Euro MPs came under heavy pressure to veto the directive. While the rejection did not prevent the European Patent Office from granting biotechnology patents, it did, however, contribute to further unpredictability<sup>100</sup>.

### Patent-Term Restoration and Grace Periods

The last two items on the six MNEs’ intellectual property rights agenda were patent restoration terms and grace periods. The former addressed the problem posed by increasing R&D periods for effective patent protection terms. As Fink-Anthe has noted, “the result of longer R&D periods has been that the usual 20 year patent terms have been reduced to an effective protection period of on average 8 years”<sup>101</sup>. In response, many countries extended the effective duration of protection periods. Leutenegger has pointed out that the US extended effective duration of patents to 14 years in 1984 and Japan in 1987. Within the EU, the introduction of a patent certificate in 1991 extended the patent protection period by 5 years to a maximum duration of 15 years of effective protection<sup>102</sup>. A number of authors have linked this policy outcome to a campaign by the *EFPIA*, which in their view was instrumental for getting the issue on to the agenda of the Commission, and for producing a draft proposal to update the European Patents Convention<sup>103</sup>.

The *EFPIA* was similarly successful with its efforts to get the Commission to introduce grace periods. Grace periods have long been in operation in the US, and the *EFPIA* argued that their existence gave US patent applicants a direct advantage over their European

<sup>97</sup> Interviews.

<sup>98</sup> Greenwood (1997), p. 192.

<sup>99</sup> See *VFA* Annual Report (1996), p. 6 and Büchel and Brauchbar (1997), p. 39.

<sup>100</sup> See EuropaBio (1997), p. 67.

<sup>101</sup> Fink-Anthe (1990), pp. 1191f.

<sup>102</sup> See Leutenegger (1993), p. 42.

<sup>103</sup> See Greenwood (1994), p. 188, Greenwood and Ronnit (1992), p. 78 and Burstall (1990).

counterparts. This mechanism, whereby inventors may delay filing by up to one year, is particularly useful for academic inventors who wish to publish their work. In Europe, prior disclosure of an invention through publication used to invalidate a European patent application<sup>104</sup>.

### **Regulations relating to the Marketing of Drugs**

A final policy issue relates to the marketing of drugs in the EU. In the early 1990s the Commission proposed a directive that sought to curtail and regulate the product information that industry provided to physicians<sup>105</sup>. For the pharmaceutical industry such a directive would have had highly negative implications since a key factor of companies' success has been their ability to influence the prescribing behaviour of physicians by controlling the flow of product information, particularly through the activities of its medical representatives<sup>106</sup>. The *EFPIA* reacted swiftly to this proposal by successfully establishing compliance among its members for a self-regulatory code for the industry's marketing and information providing activities. This code now operates with the Commission's blessing<sup>107</sup>.

A similar case involved the development and eventual passage of the "rational use packages" directive adopted in 1992 where the *EFPIA* made a significant impact upon issues of wholesale distribution, classification, labelling and advertising. This included undertaking a number of information studies on behalf of the Commission to establish the appropriate type of regulatory detail<sup>108</sup>.

### **The Political Influence of the Six Pharmaceutical MNEs**

Both the three German and the three Swiss MNEs were politically highly active at the EU level. Through their European Associations - the *SAGB* and the *EFPIA* - the six MNEs participated intensively in European policy-making processes<sup>109</sup>. Although these associations are quite different in format – the *SAGB* has individual MNEs as its members whereas the

<sup>104</sup> See EuropaBio (1997), p. 67.

<sup>105</sup> See Greenwood (1994), pp. 188f.

<sup>106</sup> See Greenwood (1988).

<sup>107</sup> See Greenwood (1994), p. 189.

<sup>108</sup> Ibid.

*EFPIA* is made up of national associations – the six MNEs supported them equally strongly<sup>110</sup>. A German executive commented that “from a practical point of view, it does not make any difference that we are a direct member of the *SAGB* and only an indirect member of the *EFPIA*”. Moreover, there was no visible difference in the level of involvement between the Swiss and the German MNEs. Although Switzerland is not a member of the EU, all three MNEs were highly active at the EU level of policy-making. Sandoz was a founding member of the *SAGB* and Switzerland is a permanent member of the five country executive committee of the *EFPIA*<sup>111</sup>. Executives from the three MNEs are not only represented in all committees, but also chair some of them. A Novartis executive, for example, chairs *EFPIA*’s important intellectual property rights committee.

With regard to policy outcomes, the picture for the six MNEs was arguably brighter at the European level than at the national level. While there have been political defeats - most notably directives 90/219 and 90/220 and the rejection of the directive for biotechnology patents - both the *SAGB* and the *EFPIA* were successful in a number of issue areas with their efforts to shape policy outcomes according to their preferences. Regarding biotechnology regulations, the *SAGB*’s initiative for a biotechnology co-ordination group was effective in diluting the influence of DG XI and, together with the *EFPIA*, it was successful with its lobbying efforts for a centralised European approval agency in the UK – then considered to have been a biotechnology-friendly country. The *EFPIA* has been no less successful. Although strangely quiet with regard to the TRIPS Agreement, it managed to get the Commission to drop its plan for an information directive in the late 1980s, and during the 1990s, it succeeded with its proposals for an extension of effective patent protection periods and the introduction of grace periods. The only real defeat for the *EFPIA* and the *SAGB* was the European Parliament’s rejection of the biotechnology patent directive in 1995. A slightly modified version of that directive was, however, ratified by the EP in 1997.

Turning now to an explanation of these policy outcomes, it appears that at the European level interests and institutions were of critical importance for an explanation of MNEs’ political influence. In contrast to domestic policy-making processes in both Germany and Switzerland, economic and political circumstances were of lesser importance.

Interests must clearly feature prominently in an explanation of the two directives for the approval of production facilities and research projects. When in 1990 the industry-unfriendly

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<sup>109</sup> See VFA Annual Report (1996), pp. 18f and Ronnit (1997), pp. 87ff.

<sup>110</sup> Interviews.

<sup>111</sup> The four other countries are Germany, Italy, France and the UK

directives 90/219 and 90/220 were passed, industry representation in this area was highly ineffective while environmental groups were vocal and well organised<sup>112</sup>. However, when the pharmaceutical industry improved the effectiveness of its interest representation in this policy area with the establishment of the *SAGB*, the situation changed significantly. A number of authors have argued that the *SAGB* was instrumental for the creation of institutional structures within the Commission that diluted the influence of environmental concerns<sup>113</sup>. However, there was also an institutional factor behind MNEs varying political influence in this issue area. As has been pointed out above, a number of authors have argued that the transfer of responsibility for the two directives from the industry-friendly DG III to DG XI (Environment and Consumer Protection) has also been an important factor behind the negative policy outcome in 1990.

With regard to the political successes of the *EFPIA* – the *EMEA*, grace periods, patent restoration terms and directives relating to the marketing of drugs – it appears that these can be more attributed to institutional linkages. Greenwood has argued that *EFPIA*'s involvement in the governance of marketing standards bears all the hallmarks of neo-corporatism. By offering an alternative set of regulations, the *EFPIA* fended off a regulatory threat and became part of the policy implementation structure of the Commission<sup>114</sup>. Similarly, the *EFPIA* provided the blueprint for the extension of patent protection periods for in Europe, when the Commission had initially been reluctant to do so. It also gave encouragement to the idea of the creation of the *EMEA* to ensure recognition of medical products throughout member states and also to ensure faster approval processes. A number of studies have argued that the *EFPIA* became through these initiatives ingrained within the structures of policy implementation, so that, in effect, a neo-corporatist style, European “private interest government” relationship had been established, where the Commission delegated regulatory authority to the *EFPIA*<sup>115</sup>.

Finally, institutional structures were also an important factor behind industry's defeat over the directive for biotechnology patents. Unlike the just mentioned policy issues, this directive was drafted under a decision-making procedure that involved the European Parliament, the “traditional home” of environmental concerns. Greenwood has noted that as a result, the issue

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<sup>112</sup> See Bandelow (1997), pp. 155f and Bandelow (1999), pp. 99-107.

<sup>113</sup> See for example Bandelow (1999), p. 135, Ronnit (1997), p. 92, Pedler and van Schendelen (1994) and Greenwood 1997, p. 123

<sup>114</sup> See Greenwood (1997), p. 122.

<sup>115</sup> For the argument that *EFPIA*'s successes were based upon clientilistic relationships with the relevant parts of the Commission see Greenwood and Ronnit (1992), p. 95, Greenwood (1994), pp. 185-189 and Greenwood (1997), Chapter 3.

became highly politicised and the exclusive relationship between the Commission and the pharmaceutical industry was disrupted<sup>116</sup>. In the end, intense lobbying activities by environmental interest groups led Euro MPs to reject the industry-inspired Commission draft that would have clarified the conditions under which biotechnology inventions could have been patented<sup>117</sup>. Moreover, it has been pointed out that the pharmaceutical industry had in the past enjoyed a somewhat ambivalent relationship with the parliament. Sassen, for example, has noted that the pharmaceutical industry had in the past caused considerable irritation by literally flooding the EP with amendments, and there were instances where committee rapporteurs refused to meet industry representatives<sup>118</sup>. However, it appears that the industry has recently experienced something of a learning curve in coming to terms with the Parliament's increasing status. After losing the key debate in Parliament, the *SAGB* and *EFPIA* co-sponsored an *EP/Biotechnology Forum* in April 1996 to help promote mutual understanding<sup>119</sup>. One year later, in 1997, the European Parliament passed a slightly different version of the directive.

In short, similar to the national level, the six MNEs' political influence at the EU level has been varying across policy issues. However, unlike as in Germany and Switzerland, these variations could be explained by institutions and interests since at the European level these two explanatory factors varied across policy issues. First, it was argued that with regard to biotechnology issues, the effectiveness of the pharmaceutical industry's interest representation activities improved strongly during the 1990s, and that a number of authors have linked this development to more industry-friendly policy outcomes. Second, it was pointed out that European directives were passed under various policy-making procedures and that a number of studies have noted that when only the Commission was involved, the pharmaceutical industry was considerably influential. In other words, variations in the institutional arrangements of the policy-making process could indeed explain the political influence that the pharmaceutical industry was capable of exerting.

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<sup>116</sup> Greenwood (1997), p. 23.

<sup>117</sup> Ibid., p. 192.

<sup>118</sup> Sassen (1992).

<sup>119</sup> See Greenwood (1997), p. 48.

## The Six German and Swiss Banks

Similar to the pharmaceutical sector, the European level of policy-making was also relevant for the six banks. In fact, during the period from the mid-1980s to the mid-1990s, a number of important policy initiatives were undertaken at the EU level to liberalise the European market for financial services. Externally, this involved the GATS Agreement for Financial Services and internally, a number of directives to establish a single European market for financial services. The following sections will now analyse the extent to which these policy outcomes corresponded to the six banks' preferences and how one can explain the political influence that banks were capable of exerting.

Before, however, turning to these issues, a brief word about European Monetary Union is in order. Clearly this issue has been of pivotal importance for the German banks as it was sure to have profound implications for their business. These implications range from the outright loss of some business segments – e.g. currency and government bond trading between members of the single currency – to more intangible, strategic issues, such as for example whether the single currency might erode banks' traditional retail funding bases (as a result of greater choice for depositors) or whether increased competitive pressures would lead to a new wave of IPOs and M&As. However, interviewees pointed out that the German banks did not enter the debate about the design of the EMU until 1996<sup>120</sup>. As one has noted, “although the Maastricht Treaty laid down a precise timetable for EMU in 1991, the German banks did only get politically involved in 1996 when it was becoming increasingly probable that EMU would happen”<sup>121</sup>. Hence this issue is clearly outside the timeframe of this study.

### GATS Agreement for Financial Services

The GATS agreement for Financial Services - negotiated under the auspices of the Uruguay Round, but only concluded in 1997 - has so far been the most significant multilateral effort to put trade in financial services in a framework based on the principles of natural treatment (Annex XXII), market access (Annex XVI) and *most favoured nation status (MFN)* - the principle that concessions or access awarded to one country must be extended to all

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<sup>120</sup> Interviews.

<sup>121</sup> Interview.

signatories<sup>122</sup>. While the rules for merchandise trade served as a model, the GATS also had to break a lot of new ground since the “non-tradable” nature of many services required a considerably different approach. To be meaningful, an agreement on trade in services needed to cover both cross-border trade (external liberalisation) and establishment (internal liberalisation). As a result, the scope of the agreement was extended beyond border trade to investment and the GATS became one of the first multilateral frameworks to cover elements of investment rules. Furthermore, the agreement also contained provisions on capital transfers, which made the GATS also one of the first multilateral sets of rules on the capital account<sup>123</sup>. The six banks strongly supported the GATS negotiations and the attempt to extend the principles of MFN, natural treatment and market access to financial services. As the *FAGB* put it,

“the GATS provides a valuable opportunity to commit to liberalisation in the multilateral context. Through the MFN principle, commitments made under the GATS have the particular advantage of guaranteeing non-discriminatory treatment to all WTO Member countries, small and large alike”<sup>124</sup>.

Prior to the agreement, market access was granted on the basis of bilateral reciprocity. While liberal in principle<sup>125</sup>, this framework became increasingly problematic for banks during the 1980s and 1990s. Kono has noted that as the scale of cross-border financial transactions and foreign direct investment grew rapidly during the last decade, some form of “internationalised intermediation” became increasingly necessary<sup>126</sup>. Moreover, banks were

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<sup>122</sup> Another significant attempt to liberalise capital movements was the OECD Capital Movements Code which required OECD Members to progressively abolish between one another, restrictions on movements of capital to the extent necessary for effective economic cooperation. See Trebilcock and Howse (1999), p. 292.

<sup>123</sup> See Sorsa (1997), p. 6. It should be noted in this context that trade liberalisation in financial services and the opening of the capital account are two distinct issues. The GATS focused upon seeking improvements in the terms of conditions of market access and non-discriminatory treatment for foreign suppliers of financial services, and not on the question of how far and how fast a government should liberalise capital account transactions. It is, of course, true that Members are required to allow international transfers and payments for transactions relating to their specific commitments under the GATS, some of which may involve capital account transactions. However, the GATS permits members to take prudential measures aimed to ensure, among other things, the integrity and stability of the financial system. See Kono (1997), p. 23.

<sup>124</sup> *FAGB* Annual Report (1998), p. 55. For a similar view see *SBA* Annual Report (1989/90), p. 106.

<sup>125</sup> The IMF has noted that the principle of reciprocity represents a liberal outlook but nevertheless leaves room for protectionism as a result of restrictive interpretation. See IMF (1989a).

<sup>126</sup> Kono (1997), p. 1. In 1995, worldwide capital exports exceeded US\$50bn, which compares to less than US\$15bn in 1985. See Kono (1997), p.13).

complaining that in many emerging and developing countries contestability indicators suggested that competition was significantly restricted<sup>127</sup>.

Nevertheless it was neither the lobbying activities of the financial services industry nor these “narrow” financial services-specific concerns that led to the inclusion of financial services in the Uruguay Round. Rather it was the insistence of the US and the lobbying of its domestic service industry<sup>128</sup>. In fact, Trebilcock and Howse have noted that the inclusion of financial services was part of a larger US strategy to extend the multilateral trade framework to services in general<sup>129</sup>. A major motivation for the US initiative was the belief that unlike many basic manufacturing sectors where it was losing market share to NIC competitors, service sectors remained a strength of the US - especially sectors like financial services and telecommunications<sup>130</sup>.

Similar to the TRIPS agreement, the European Commission played only a passive role, at least in the initial stages. This changed, however, in the mid-1990s when the US abandoned its leadership role after an extension of the deadline for an agreement to December 1995 failed to produce sufficient progress. The US took the view during the final period of negotiations that other countries had not offered sufficient liberalisation commitments to justify US adherence to a multilateral, MFN-based framework in financial services<sup>131</sup>. Although 29 countries had improved their schedule of commitments or reduced the scope of their MFN exemptions by 1995, the US was dissatisfied with the results and stated its intent to take a MFN exemption and to proceed with bilateral and regional negotiations<sup>132</sup>. With the US having effectively pulled out, the EU became instrumental in preventing the agreement from falling apart. In fact, it was the EU’s initiative that led to an interim agreement (to expire in 1997) and it was the EU that during this period persuaded developing countries to put forward further liberalisation measures<sup>133</sup>.

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<sup>127</sup> See Sorsa (1997), p. 28.

<sup>128</sup> See Gelb and Sagari (1990), p. 1.

<sup>129</sup> Trebilcock and Howse (1999), p. 278. In fact, as early as the 1982 GATT Ministerial Meeting, the US was pressing for GATT-based negotiations on services. See Drake and Nicolaïdis (1992).

<sup>130</sup> See Trebilcock and Howse (1997), p. 278. Although at the level of general principle the US espoused the idea that negotiations on services should have a comprehensive scope, the US position on the definition of services themselves had the effect of focusing the negotiations on those sectors of most export interest to the US and other developed countries (e.g. cross border transactions in sectors such as telecommunications and financial services), while excluding liberalisation of factor movements, especially labour, where developing countries might have a comparative advantage. See Trebilcock and Howse (1999), p. 279.

<sup>131</sup> With these principles WTO member countries would have had access to the US market, even if their own financial services markets were a lot less open. See Trebilcock and Howse (1999), p. 296.

<sup>132</sup> See Trebilcock and Howse (1997), pp. 296ff.

<sup>133</sup> See SBA Annual Report (1998), pp. 120f.

The German and Swiss banks as well as the Swiss government, were during this period strongly on the side of the EU. While both the German and Swiss banks agreed with the US that developing countries' proposed liberalisation measures were not fully satisfactory and did not go far enough in guaranteeing market access, they supported the stance of the EU. Both the *FAGB* and the *SBA* made it clear during this period that the benefits of putting financial services under MFN status clearly outweighed the negative effects of unsatisfactory liberalisation measures of a few countries, and welcomed efforts by the EU to rescue the agreement<sup>134</sup>. In the end, the EU's initiative was not without success. By December 1997, about two-thirds of WTO members had made some specific market access commitments in financial services and the US withdrew its exception<sup>135</sup>.

The *Swiss Bankers' Association* noted that this success was preceded by intensive efforts of European banks and insurance companies, which together with US financial institutions approached developing countries in order to convince them to put forward more far-reaching liberalisation policies<sup>136</sup>. However, the final outcome was not welcomed as an unconditional success by the six banks. In fact, in their view the GATS framework - and the actual multilateral liberalisation undertaken - were disappointing since the GATS allowed for too much discretion in making liberalisation commitments<sup>137</sup>. One German executive commented that

“the GATS framework with country-specific reservations and many exceptions fails to meet many tests for a ‘good’ agreement. Market access is very conditional and temporary and many countries made MFN exemptions that maintain reciprocity and discrimination in market access”.

Indeed, Sorsa has pointed out that the agreement contained weak capital account provisions and security of market access was limited by many exceptions<sup>138</sup>. However, while the six banks expressed disappointment that liberalisation results were only limited and not all

<sup>134</sup> See *FAGB Annual Report* (1998), p. 120f and *SBA Annual Report* (1995/96), pp. 102f.

<sup>135</sup> See Sorsa (1997), p. 5.

<sup>136</sup> See *SBA Annual Report* (1998), pp. 120f.

<sup>137</sup> Trebilcock and Howse (1999, p.280) have pointed out that the GATS contains an MFN obligation that applies to services generally, subject to reservations taken by individual members. National treatment applies only where members have made specific commitments. In these areas, however, the GATS creates an institutional framework for service transactions, offers a neutral forum for dispute settlement and enforcement and increases security of market access by binding liberalisation. See also Sorsa (1997), p. 6.

<sup>138</sup> Sorsa (1997), pp. 5f.

developing countries agreed to the proposed liberalisation measures, they nevertheless noted that the agreement was a step in the right direction<sup>139</sup>. One Swiss executive argued that

“the agreement has the potential to consolidate financial sector reform and promote the efficient allocation of savings world-wide. Moreover, it forms a basis for future liberalisation in the sector”<sup>140</sup>.

### **Liberalisation of Financial Services in the EU**

The EU level of policy-making has also been important for the six banks with regard to internal liberalisation measures aimed at creating a unified European banking sector – one of the main goals of the Single European Act of 1986.

First attempts to create a single European financial market date back to the 1970s. At that time, some countries already removed restrictions on capital movements and the European Commission issued several directives<sup>141</sup>. Co-operation between the regulatory authorities of EU member states began in 1973 through the informal *Contact Committee* and was intensified in 1979 through the establishment of a formal Advisory Committee to the European Commission<sup>142</sup>.

These measures, while certainly important, failed, however, to make significant progress and it was only in the aftermath of the SEA that attempts at full-scale liberalisation were undertaken<sup>143</sup>. New momentum for the creation of a single market in financial services came particularly from a new approach to liberalisation: instead of trying to harmonise all European regulations – something, which the experience of the 1970s and 1980s showed was very tedious and time-consuming – liberalisation within the context of the SEA was based on

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<sup>139</sup> Interviews. See also *FAGB Annual Report* (1998), p. 50 and (1996), p. 127.

<sup>140</sup> Interview.

<sup>141</sup> Desirability of freedom of establishment was first mentioned in a directive in 1973 (73/183) and further developed in 1977 by agreeing on common definitions of regulatory matters (77/780). Additionally, a number of directives intended to facilitate the unification of Europe’s capital markets and to create common standards for investor protection were adopted, ie. directive 79/279 for the issuing of securities (revised through directive 82/148), directive 80/390 for prospectuses relating to IPOs (revised through directives 82/148, 87/345 and 94/18) and directives 83/350 for a consolidated supervision. See Huang (1992), p. 56 and Hirschowicz (1996), pp. 289ff.

<sup>142</sup> See Huang (1992), p. 56.

<sup>143</sup> Ibid., p. 67.

the principles of mutual recognition, home country rule, and minimum regulatory harmonisation.

Mutual recognition entailed the granting of market access to an institution from another EU Member State, based on the institution's compliance with regulatory requirements in its home country. The related principle of home country rule stipulated that the regulatory authorities in the home country retained responsibility for prudential supervision of the institution, even for business activities taking place in another EU country. Hence, as Hufbauer has observed, market access was not granted on terms of compliance with the regulation of the "importing country" (as with National Treatment) but on condition that the entity met relevant regulatory requirements in its own country<sup>144</sup>. However, since mutual recognition and home country rule necessarily entailed reliance on another state's regulators and regulations, an essential quid pro quo was a set of minimum standards sufficient to provide even the country with the strictest regulatory requirements with the needed confidence in the regulatory regimes of the others. This was reflected in the third principle, minimum regulatory harmonisation.

The minimum standards to which EU Member States' regulatory regimes must conform were set out in the 1989 Second Banking Directive, which came into force in 1993. Kim has noted that these standards covered a very wide range of regulatory requirements, including initial capital requirements, disclosure of credit institution's major shareholders, limitations on the size of participation in non-financial undertakings, standard solvency ratios, and permissible activities<sup>145</sup>. The Third Life and Non-Life Insurance Directive in 1994 and the Investment Services Directive in 1996 – complemented by a series of other directives defining key concepts and establishing essential prudential requirements<sup>146</sup> - completed the regulatory framework. As a result of these directives, the EU regulatory framework granted EU financial institutions and incorporated foreign subsidiaries in the EU the right of operation in all EU countries when they were registered in just one - the so-called "single passport"<sup>147</sup>.

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<sup>144</sup> See Hufbauer (1990).

<sup>145</sup> See Kim (1993), p. 319. Harmonisation of these standards occurred principally through directives 89/646, 89/647 and 89/299. See Hirschowicz (1996), p. 282.

<sup>146</sup> Most importantly these were directives 93/22 and 93/6, which aimed at levelling the playing field with regard to securities trading according to the motto similar business, similar risks, similar rules. Insider trading rules were already harmonised in 1989 through directive 89/592. See Hirschowicz (1996), p. 297.

<sup>147</sup> For a detailed discussion see Loheac (1991), WTO (1995, 1997), Weidenfeld (1996), Huang (1992), p. 67, Hirschowicz (1996), p. 277, Kim (1993), pp. 318-321 and Kono (1997), p. 19.

Chapter 3 has argued that the six banks strongly advocated the harmonisation of regulatory standards on a global scale in order to promote the development of efficient capital markets. Judged by this yardstick, recent liberalisation and harmonisation measures within the EU clearly corresponded to the six banks' preferences. Indeed, Harris and Piggot have argued that liberalisation of financial services between EU member states showed significant positive effects on financial sector efficiency<sup>148</sup>.

However, despite these achievements, the six banks have been complaining that there was still a lot of unfinished business that was preventing a unified European capital market. One German executive argued that

“while the measures adopted by the European Commission in the late 1980s and early 1990s certainly laid the foundation for a unified regulatory framework for traditional banking services, there is still considerable regulatory muddle when it comes to capital markets which is impeding progress towards a single market in financial services”<sup>149</sup>.

One frequently voiced criticism was the lack of a single European regulator with a clear mandate to standardise rules in the wholesale capital markets<sup>150</sup>. In the words of one executive,

“having to deal with 15 regulators is enormously time consuming and, in my view, does not help to overcome the fragmentation of Europe’s capital markets. Surely the absence of a single regulator has negative implications for market efficiency and liquidity”<sup>151</sup>.

In fact, a number of interviewees agreed that despite a number of directives that were intended to do the same for securities markets what the “single passport” rules did for banking, securities regulation and supervision continued to vary significantly across Europe<sup>152</sup>. There are wide variations in disclosure requirements for companies wanting to issue securities and there are significant differences in trading rules, accounting standards and tax treatment<sup>153</sup>. As one interviewee has put it,

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<sup>148</sup> See Harris and Piggot (1997).

<sup>149</sup> Interview. See also “No SECs please, we’re European” *The Economist* August 21 1999 pp. 70f.

<sup>150</sup> Interviews.

<sup>151</sup> Interview.

<sup>152</sup> Interviews.

“retail investors still face a bureaucratic battle and high fees if they want to invest in foreign shares, which are typically listed on a foreign stock exchange and cleared and settled under local rules. Many European countries use bearer share certificates rather than maintain a shareholder register, reflecting different attitudes to shareholder rights and taxes. Companies are subject to different rules on accounting, information disclosure and the treatment of minority shareholders”<sup>154</sup>.

In other words, while the six banks welcomed the initiatives by the European Commission to unify Europe’s capital markets, they also argued that taxes, regulatory and supervisory standards, listing requirements and accounting rules required far greater harmonisation if this goal was to be achieved. By the mid-1990s, in their view, Europe’s capital markets were still considerably fragmented<sup>155</sup>.

### **The Political Influence of the Six Banks**

In contrast to the pharmaceutical sector, all of the analysed policy outcomes largely corresponded to the six banks’ policy preferences. While certainly both the GATS Agreement for Financial Services and the internal EU liberalisation measures were not optimal from the six banks’ point of view, both policy outcomes nevertheless went in the right direction and significantly improved the regulatory and supervisory framework. While the GATS Agreement established a rule-based system for trade in financial services and provided for internationalised dispute settlement mechanisms, EU liberalisation measures harmonised a substantial amount of national regulations and thereby improved market efficiency and liquidity.

Unlike as in the pharmaceutical sector, however, there was little interaction between the six banks and the institutions of the EU. With regard to the GATS, this might not be too much of a surprise since this was primarily an American initiative. When the US withdrew from the negotiations and the EU took over, the main obstacle for a conclusion of the agreement was developing countries’ resistance for further liberalisation. The *Swiss Bankers’ Association* pointed out that during the period when negotiations were in limbo, a large

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<sup>153</sup> Interviews.

<sup>154</sup> Interview.

<sup>155</sup> Interviews.

number of European banks intensively lobbied the governments of developing countries to get them to agree to further liberalisation measures<sup>156</sup>. An official from the *FAGB* commented that the problem was not with the European Commission, but rather with developing countries' governments, which were highly sceptical about extending their liberalisation commitments<sup>157</sup>. Since this study is, however, about banks' political influence in their home countries – and not host countries – it is beyond the scope of this study to analyse this additional aspect of banks' political strategies further.

However, when it came to the liberalisation process within the EU, the six banks' lack of political action has been somewhat surprising. Chapter 6 has pointed out that EU directives have been important for both German and Swiss regulatory reforms. It was shown that as a result of EU directives, Germany's supervisory structure changed considerably during the 1990s. Indeed, the *FAGB* noted that the supervisory framework in which German banks operate had been to a significant degree designed in Brussels<sup>158</sup>. Similarly, Switzerland's financial market reforms were strongly affected by EU directives. Hirschowicz has noted that although Switzerland was not a member of the EU, it still had to carefully study EU directives before implementing new laws in order to ensure compatibility<sup>159</sup>. In similar vein, Däniker has pointed out that liberalisation within the EU had a strong impact on Swiss reforms<sup>160</sup>. Yet despite the obvious impact that EU directives had on both the German and Swiss regulatory framework, neither the German nor the Swiss banks were politically active at the EU level.

Although both the *FAGB* and the *SBA* are members of the *European Bank Federation (EBF)*, neither the German nor the Swiss Association described their working relationship as particularly intensive. As one official at the *SBA* has put it, "the *Swiss Bankers' Association* is a member of the *EBF* in order to receive first-hand information about policy developments of significance for the Swiss financial centre<sup>161</sup>". Similarly, the *FAGB* has referred to the *EBF* as more of an "information providing agency" than an association for pro-active interest representation. One interviewee argued that

"certainly have there been important directives, but they did not get much attention here."

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<sup>156</sup> *FAGB Annual Report (1996/97)*, p. 78.

<sup>157</sup> Interview.

<sup>158</sup> *FAGB Annual Report (1996)*, pp. 53-60.

<sup>159</sup> See Hirschowicz (1996), pp. 297f.

<sup>160</sup> See Däniker (1998), pp. 5-7.

<sup>161</sup> Interview. For a similar view see Hirschowicz (1996), pp. 457f.

Our focus has been on the implementation stage of directives coming from Brussels”<sup>162</sup>.

How can one explain this reluctance of both the German and the Swiss banks to actively engage at the European level? Essentially there appear to be three explanations. First, unlike the *SAGB* and the *EFPIA* in the pharmaceutical sector, the *EBF* usually does not appear on the list of the most visible European Associations. While the literature on the activities of European business associations has been rapidly expanding during the 1990s, there has not yet been a major study analysing the activities of the *European Bank Federation*. Indeed, one official at the *EBF* noted that “many banks do not know that we exist. Maybe we do not have the desirable level of visibility”<sup>163</sup>.

Second, since financial liberalisation was pursued through directives – which are addressed to member states and implemented through secondary acts of legislation – national governments retained a certain degree of decision-making power. This was apparently enough for the six banks to concentrate their political strategies at the national level. The previous chapter has pointed out that all three German banks were through the *FAGB* actively involved in the process of translating European directives into German law. Similarly, the *SBA* was strongly involved in the drafting of reform acts that were based on EU directives. Certainly also important in this respect has been that both national bank associations enjoyed excellent relationships with their national regulatory authorities, while the *European Bank Federation* has not been singled out for its close relationship with the European Commission.

A final explanation for the six banks' reluctance to politically engage at the European level has to do with the fact that during the last two decades regulatory and supervisory issues were also tackled in a larger international context, and hence the European Commission was not always the right institution for pro-active interest representation.

A large number of banking crises in both developed and developing countries since the early 1980s prompted central bankers and supervisory authorities almost everywhere to improve the quality of banking supervision by establishing international banking standards. Internationalisation and the growing integration of the world's financial markets have been particularly significant in this context. Chapter 2 has pointed out that large parts of banks' business were highly mobile and could be relatively easily shifted between financial centres. As a result, it became increasingly necessary for national regulators to agree on measures to

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<sup>162</sup> Interview.

<sup>163</sup> Quoted in Josselin (1997), p. 154.

guarantee the safety of the international banking system and to prevent competitive deregulation<sup>164</sup>.

Most influential on an international scale has been *the Basle Committee on Banking Supervision (Basle Committee)*, established by the central bank Governors of the G-10 in 1974 in the aftermath of serious disturbances in international currency and banking markets<sup>165</sup>. As a part of the Bank for International Settlements (BIS) – the “central bank of central bankers”<sup>166</sup> – the Committee’s objective is to formulate broad supervisory standards and guidelines in order to close gaps in the supervisory net and to improve supervisory understanding and the quality of banking supervision<sup>167</sup>. Contrary to the liberalisation objectives of the GATT and the OECD, the *Basle Committee* is not primarily concerned with deregulation, but with an appropriate and up-to-date control of risks in the international banking business<sup>168</sup>. To this end, a number of core principles have been developed to promote effective banking supervision - the so-called *Basle principles*<sup>169</sup>. These principles propose minimum standards for supervision methods, information and disclosure requirements, licensing, ownership transfer and liquidation<sup>170</sup>. Moreover, they suggest prudential rules and requirements to help financial institutions to measure and manage their exposure to risk<sup>171</sup>. Although the *Basle Committee* does not have any supranational authority - and its recommendations have no binding power - the Committee is very influential<sup>172</sup>. In fact, a number of studies have pointed out that the EU directives for the completion of the single

<sup>164</sup> See Huang (1992), pp. 51f. and Pöhl (1990).

<sup>165</sup> Additionally there are OECD codes for liberalisation - which are supervised by a standing committee (Committee on Capital Movements and Invisible Transactions) - aimed to facilitate the communication between national authorities and to agree on minimal standards for member countries.

<sup>166</sup> The BIS was founded in Basle in 1930 as an international financial organisation to settle the problem of the German reparation payments after the First World War. The BIS evolved into a forum for central bankers to discuss and coordinate banking regulations and to promote international financial stability. See Kono (1997), p.30.

<sup>167</sup> See BIS (1989), p. 1.

<sup>168</sup> See Huang (1992), p. 55.

<sup>169</sup> The Basle principles are voluntary minimum standards, which allow for considerable diversity. They can be tailored to meet country circumstances and to permit a degree of experimentation on "what works best". See Lewis (1993).

<sup>170</sup> These recommendations include the 1983 Accord on minimum requirements for cross-border supervision (revised in 1990, 1992 and 1994), the 1990 Accord in information exchange between national regulators and the 1988 Accord on capital requirements which include definitions for capital, risk measurement and standards. More recently, in 1996, the Basle Committee and the Offshore Group of Banking Supervisors (which comprises supervisors of major offshore centres) released a report on the Supervision of Cross-Border Banking. In 1997, the Basle Committee, in close collaboration with supervisory authorities from 15 developing countries from Eastern Europe, Latin America and Asia, released the Basle Core Principles for Effective Banking Supervision. The document sets out 25 principles that represent the basic elements of an effective supervisory system, covering topics such as licensing, formal powers of supervisors and methods of banking supervision. See Hirschowicz (1996), pp. 293ff, Kono (1997), p. 30 and BIS (1996, 1997a, 1997b).

<sup>171</sup> The most-well known principle is the minimum capital adequacy ratio of 8 per cent. See Goldstein (1997).

<sup>172</sup> See Huang (1992), p. 55.

market in financial services largely reflected recommendations by the *Basle Committee*<sup>173</sup>. Unfortunately it is, however, beyond the scope of the present study to analyse if and how the six banks sought to influence the drafting of guidelines at the BIS.

## Conclusion

Having analysed the political influence of German and Swiss pharmaceutical MNEs and banks at the EU level of policy-making, this study cannot really endorse wholeheartedly any of the hypotheses about political strategies of organised interests reviewed at the beginning of the chapter. Political influence and strategies varied considerably not only across the two sectors, but also within them<sup>174</sup>.

The first point to make, however, is that the differences were not between MNEs from Germany and Switzerland, but rather between the pharmaceutical and the banking sector. Although Switzerland is not a member of the EU, the three Swiss pharmaceutical MNEs were politically as active at the EU level as the three German pharmaceutical MNEs. Sandoz and Hoechst were among the founding members of the *SAGB*, and both countries are represented in the executive council of the *EFPIA*. In turn, both associations have been very active. A number of studies have argued that both the *EFPIA* and the *SAGB* developed strong ties with the Commission, which included elements of neo-corporatism<sup>175</sup>. Moreover, it was shown that both the *SAGB* and the *EFPIA* were able to exert considerable political influence and as such defied caricatures of European groups as weak and ineffective. Greenwood and Ronnit have noted that “although the *EFPIA* has not had its own way in every instance, it has clearly had a considerable impact upon the regulatory flavour of EC action in the sector, to the extent that its major demands have been incorporated”<sup>176</sup>. In similar vein, Bandelow has referred to the *SAGB* as one of the most effective industry organisations in Brussels<sup>177</sup>.

In stark contrast to the pharmaceutical MNEs, the six German and Swiss banks were largely uninvolved at the European level of policy-making and continued to concentrate their political strategies on their time-tested domestic channels of political influence. It was argued that this phenomenon could be explained by three factors: first, European directives are

<sup>173</sup> See Hirschowicz (1996), p. 207, Cornet (1990), p. 279 and *FAGB Annual Report* (1994), pp. 54ff.

<sup>174</sup> See for example Ronnit 1997, p. 83.

<sup>175</sup> See for example Greenwood/ Ronnit (1992) and Greenwood (1997).

<sup>176</sup> Greenwood and Ronnit (1992), p. 82.

<sup>177</sup> Bandelow (1999), p. 108.

implemented as secondary acts of legislation, and both the German and the Swiss banks enjoy excellent relationships with domestic regulators. Second, in contrast to the European associations of the pharmaceutical industry, the *EBF* has not been singled out as a particularly active and highly visible organisation. Finally, the fact that many EU directives were based on guidelines from the *Basle Committee* made the European Commission not necessarily the most appropriate level for pro-active interest representation.

However, differences in interest representation activities were not only between the two sectors but also within them. While in some issue-areas the pharmaceutical industry's associations were able to build relatively exclusive relationships with the Commission – what Greenwood has called “clientilistic relationships”<sup>178</sup> – other policy areas were characterised by a more confrontational policy-making style, e.g. the failed directive for the patenting of genetic modifications.

In short, an analysis of the pharmaceutical MNEs' and banks' political strategies at the European level has clearly shown that there was no single pattern of firm political action. Instead, the nature of policy networks varied significantly and there was a whole spectrum of relationships between the various actors, which ranged from tightly integrated policy communities to looser and more fragmented issue networks<sup>179</sup>.

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<sup>178</sup> Greenwood (1994), p. 185.

<sup>179</sup> For the argument that there are significant variations in the nature of policy networks at the European level see Mazey and Richardson (1993) and Greenwood (1997), pp. 15f.

## Conclusion

The purpose of this study was to analyse the economic policy preferences and political influence of six German and six Swiss pharmaceutical MNEs and banks. To this end, the analysis has tried to synthesise various strands in the IPE literature: from Milner it incorporated the argument that MNEs' trade policy preferences were shaped by the extent and nature of their internationalisation process; from Krueger, Bhagwati and others it took the insight that economic policy preferences could be price mechanism promoting, distorting or suspending; from the public choice literature the importance of interests and incentives for analysing political influence; and, finally, from the corporatist and neo-corporatist literature the centrality of institutions for explaining policy outcomes. It was argued that while these studies provided a useful starting point for the analysis, there were some gaps in the literature that became apparent when one tried to turn these insights into an explanatory framework for analysing MNEs' economic policy preferences and political influence during the period from 1985 to 1995.

First, it was argued that the functioning of price competition was not only affected by trade policies but also by domestic policies. Hence Milner and other's explanatory framework excluded a number of important policy areas from the analysis. Moreover, it was pointed out that even within the category of trade policy, obstacles to freer trade began to shift during the 1980s and 1990s from "at the border" to "behind the border" policy issues - domestic policies that mutated with the increasing integration of national economies into obstacles to international trade. In short, there was a strong case for incorporating domestic policies into the analysis, and the literature did not offer a method to explain MNEs' preferences with regard to those issues. This study argued that internationalisation was unlikely to be of much help in providing an explanation and suggested instead two other explanatory factors: MNEs' business focus and sectoral characteristics. Put differently, this study did not seek to disprove the argument that MNEs' trade policy preferences were shaped by the extent and nature of their internationalisation process, but rather argued that there was a case for going beyond this framework of analysis in order to account for MNEs' preferences with regard to domestic

policies. German and Swiss pharmaceutical MNEs and banks seemed to make good case studies for analysing the importance of internationalisation for MNEs' policy preferences since the two sectors differed considerably in the extent and nature of their exposure to international markets. While pharmaceutical MNEs in both countries were always highly internationalised, banks tended, at least until recently, to be a lot less so.

Second, Chapter 1 noted that the two main approaches in the IPE literature to explain policy outcomes centred around interests and incentives on the one hand, and institutions on the other. It was argued that while both approaches were important for explaining MNEs' political influence, they suffered from a similar shortcoming; both exclude the circumstances under which policy-making took place from the analysis and hence cannot explain their impact on perceptions of self-interest and institutions. In order to remedy this shortcoming, this study suggested that both approaches needed to be supplemented by an analysis of the changing economic and political circumstances under which policy-making took place. More precisely, it was argued that the impact of circumstances on the preferences of the government, the degree of opposition from other organised interests and the extent to which MNEs' could use their internationalisation process for political leverage, was an important explanatory factor that was conditioning the political influence of MNEs. In other words, the argument was again not to disprove existing theories, but rather to add more complexity. MNEs from Germany and Switzerland were chosen for the analysis since firms in both countries enjoy broadly similar institutional linkages to the policy-making process. Comparing their political influence should thus yield evidence of the importance of institutions for MNEs' political influence and the extent to which this influence can be conditioned by changing circumstances.

Certainly such an explanatory framework implied discarding a lot of simplifying assumptions and was unlikely to lead to a parsimonious theory. However, Chapter 1 has argued that the purpose of this study was not to develop a rigorous model, but rather to analyse the interactions of a number of explanatory factors that the more parsimonious theories had difficulty accounting for. Moreover, parsimony is not the only criteria by which a theory should be judged; there is also explanatory power and range. Did the findings then vindicate the chosen approach?

## **The Economic Policy Preferences of the 12 MNEs**

With regard to MNEs' economic policy preferences, the answer appeared to be a cautious yes. It was shown that in both sectors the most important economic policy issues confronting the six pharmaceutical MNEs and the six banks were almost entirely domestic in nature, and there was evidence that in many cases internationalisation was only of little, or even no, help in explaining MNEs' policy preferences. Instead, as this study predicted, MNEs' business focus and sectoral characteristics were important explanatory factors. In the pharmaceutical sector, MNEs' policy preferences with regard to health care policies, intellectual property rights and parallel imports could be explained to a significant extent by their business focus and sectoral characteristics. Similarly in the financial services sector, the six banks' preferences regarding reforms of the domestic regulatory framework were significantly shaped by their business focus.

However, the findings were not entirely straightforward. In both sectors one could point to domestic policy issues where – apart from MNEs' business focus and sectoral characteristics – MNEs' internationalisation process was also an important explanatory factor. In the pharmaceutical sector, this was the case with intellectual property rights. In the financial services sector, it was even more clearly the case with regard to reforms of the domestic regulatory framework. Moreover, in both sectors there were policy issues in which none of the three explanatory factors was decisive for shaping MNEs' policy preferences. This was the case with biotechnology regulations in the pharmaceutical industry and with the issue of public sector banks in the German financial services sector. In both cases, MNEs' preferences were more the result of a general desire for a level playing field than of company- or sector-specific characteristics.

However, the clearest example of the potential importance of other explanatory factors was the case of the three Swiss banks' pre-1990 preference for administered competition in the domestic banking sector. Even though the Swiss banks were more internationalised than the German banks (at least during the 1980s), had a roughly similar business focus and obviously were subject to the same sectoral characteristics, their preference was almost diametrically opposed to the German banks' preference for free competition in the German banking sector. It was suggested that the three Swiss banks' preference for administered competition could be explained by national characteristics, or more precisely, Switzerland's relatively lax competition policies. So clearly the proposed explanatory framework did not always hold up. But then again, neither did the traditional explanatory logic that explained

MNEs' trade policy preferences as the result of the extent and nature of their internationalisation process. While this was certainly a plausible explanation for the six banks' support of the GATS Agreement in Financial Services, the three German pharmaceutical MNEs' preference for restricting parallel imports from other European countries fitted somewhat uneasily with this argument. After all, these were highly internationalised MNEs – both in terms of sales and production networks – and yet they were supporting measures to segment national health care markets along national lines. It was argued that sectoral characteristics could explain this phenomenon.

Judging the extent to which these policy preferences were competition-promoting has not been a straightforward task. In fact, in both sectors there seemed to have been evidence for the argument that high levels of regulation were often likely to encourage rent-seeking behaviour. In the pharmaceutical sector, one could point to the six MNEs' preference for worldwide harmonisation of patent laws and the three German MNEs' preference for segmenting European health care markets along national lines. Yet it was also noted that sectoral characteristics complicated a definitive verdict in these cases. In the financial service sector, the obvious example was the three Swiss banks' pre-1990 preference for administered competition in the domestic banking sector. However, on balance, MNEs in both sectors appeared to be more often interested in promoting competition than in distorting or suspending it. In the pharmaceutical sector, all six MNEs strongly supported competition-promoting health care policies and a regulatory framework for biotechnology that was based on scientific principles and free from government meddling. In the financial services sector, all six banks supported open international markets for financial services and advocated measures to deepen and broaden domestic capital markets and to adjust domestic regulatory and supervisory standards to international best practices. Moreover, the German banks relentlessly campaigned for a level playing field between commercial and public sector banks, and strongly supported financial liberalisation measures within the context of the Single European Act.

### **The Political Influence of the 12 MNEs**

The analysis clearly showed that interests and institutions were indispensable for an explanation of MNEs' political influence. In fact, it was possible to show that differences in the way and intensity in which MNEs articulated their interests had in some cases a visible

impact on the political influence they were capable of exerting (e.g. the six pharmaceutical MNEs' public campaign against overly strict and comprehensive biotechnology regulations). Similarly, institutions went in some cases a long way towards providing a satisfactory explanation of MNEs' political influence. For example, both the German and Swiss banks' political influence with regard to reforms of the domestic regulatory framework could be to a significant extent linked to institutional structures in these sectors. Moreover, differences in MNEs' institutional linkages to the policy-making process also had an observable impact on their political influence. Despite significant similarities in the institutional structure of the German and Swiss economic policy-making process, Chapter 4 noted that institutional linkages were more tightly knit in Switzerland and that a number of authors had recently voiced scepticism about the robustness of Germany's institutions in the face of economic change. Indeed, these observations from the macro level were visible in policy outcomes in the pharmaceutical sector: on balance, policy outcomes were a shade less negative for the three Swiss MNEs than for the three German MNEs, and there was evidence that these differences could, at least to an extent, be attributed to institutions linking MNEs to the policy-making process.

That said, however, the limitations of these two explanatory approaches became quickly visible. It was shown that in both the German and Swiss pharmaceutical and financial services sector, MNEs' political influence varied considerably across a number of policy issues despite similarly strong interests and similar institutional linkages to the policy-making process. Hence it became necessary to go beyond interests and institutions and to add more complexity to the analysis. In fact, the explanatory power of both approaches increased substantially when they were supplemented with an analysis of economic and political circumstances and their impact on the preferences of the government, the degree of opposition from other organised interests and the extent to which MNEs' internationalisation process could be used as source of political leverage. Indeed, when applied to the selected policy issues, this extended explanatory framework was able to plausibly explain variations in MNEs' political influence.

In the pharmaceutical sector, it was shown that the political influence that the German and Swiss MNEs were capable of exerting not only varied considerably between health care policies and biotechnology regulations, but was also very limited: policy outcomes in both issue areas were far from MNEs' preferences, but changes in the regulatory framework for biotechnology were less negative in their effects than health care reforms. These policy outcomes were somewhat surprising - at least when looked at through the lens of interest- and

institution-based explanations: Chapter 3 noted that all six MNEs had a strong interest in these two issue areas and plenty of incentives for political action; Chapter 4 pointed out that all six were part of an institutional structure that could be expected to award them considerable political influence. Moreover, it was noted that with regard to health care policy, MNEs in both countries were part of a highly institutionalised policy-making network while for biotechnology regulations no similar forum existed. Yet policy outcomes in health care were in both countries considerably more disadvantageous for the MNEs than were changes in the regulatory framework for biotechnology.

Admittedly, an interest-based explanation went some distance towards explaining these variations in MNEs' political influence. With regard to biotechnology regulations, MNEs in both countries launched high-profile public relation campaigns, while with regard to health care policies they relied on traditional channels of interest representation. However, it was argued that such an explanation was not entirely satisfactory. First, it failed to explain the relatively limited extent of the six MNEs' influence - both policy outcomes were far from MNEs' preferences - and, second, the counter-factual did not appear particularly plausible. While a public campaign may indeed have helped the six MNEs with regard to biotechnology issues, it appeared unlikely that a similarly forceful articulation of interests would have achieved the same result with regard to health care policy.

An analysis of economic and political circumstances shed more light on these issues. Essentially the dynamics were the same in both countries. First, it was argued that an important factor behind MNEs' inability to achieve more favourable policy outcomes was the incompatibility of their preferences with those of the state: regarding health care reforms, governments in both countries were more interested in instant cost savings than in redesigning market orders and with regard to biotechnology regulations, the German and Swiss government were keen to respond to popular safety and environmental concerns and to extend their regulatory competence to this important technology.

A second factor counting against MNEs was that in both policy areas MNEs' preferences were strongly opposed by a variety of well-organised interest groups with plenty of populist appeal. In the health care sector, these were primarily the hospitals, the main cost driver behind rising health care expenditures, and with regard to biotechnology regulation, they were coalitions of organised interests ranging from environmental protection and consumer safety groups to women's organisations and the church. It was argued that in both countries this domestic opposition was a significant factor behind the inability of the six MNEs to shape policy outcomes more to their preferences.

However, while both policy outcomes were far from MNEs' preferences, health care reforms in both countries were clearly more negative in their effects than biotechnology regulations. The crucial difference between the two issue areas was that with regard to biotechnology regulations, the six MNEs' internationalisation processes became during the 1990s increasingly a source of political leverage. It was shown that both Germany and Switzerland experienced significant economic problems during the first half of the 1990s while simultaneously the six MNEs moved an increasing share of their R&D and high value added production activities to foreign production locations with more biotechnology-friendly regulatory frameworks. In both countries a number of authors argued that these developments combined to increase the political influence of MNEs in this issue area.

In short, while interest- and institutions-based explanations provided a useful starting point for an explanation of the six pharmaceutical MNEs' political influence, they nevertheless left many questions unanswered. Supplementing the analysis with an account of the economic and political circumstances under which policy-making was taking place turned out to be of significant importance.

Like the six pharmaceutical MNEs, the political influence of the six banks also varied considerably across issue areas. On balance, however, the six banks were considerably more influential. It was shown that in both countries reforms of the domestic regulatory framework closely matched the six banks' preference for regulations that were compatible with international norms and standards, and that allowed for a broadening and deepening of capital markets. However, the six banks also suffered political setbacks. In Germany, they failed to get the German government to level the playing field between commercial and public sector banks; and in Switzerland, despite fierce opposition from the three banks, the government abolished in 1990 the conventions through which the *Swiss Bankers' Association* used to administer competition in the banking sector.

As in the pharmaceutical sector, interest- and institutions-based explanations provided a useful starting point to explain these policy outcomes and the political influence that the six banks were capable of exerting. In fact, advocates of public choice and corporatist theories would hardly find anything surprising in the German and Swiss regulatory reforms. After all, the six banks had strong incentives to lobby for these reforms and, as the analysis of Chapter 6 showed, were part of a highly institutionalised policy-making network.

However, these explanations again left a lot unanswered. Chapter 6 pointed out that there was no hierarchy of importance among the six banks' preferences that could explain why the banks were successful with their preference for regulatory reforms and unsuccessful with

their preferences for a level playing field and the banking conventions. In fact, the Swiss banks launched a high profile campaign to defend the conventions and still lost the debate. Institutional explanations, on the other hand, appeared to be more helpful to explain the variations in the six banks' political influence: with regard to regulatory reforms, the German and Swiss banks were part of highly institutionalised policy-making network, while in the case of the state-sanctioned privileges for public sector banks and the banking conventions, no comparable networks existed. Although there seemed to be some truth to this argument, it was nevertheless not entirely convincing since it implied that the six banks would have persisted with their preferences for a level playing field and the banking conventions if institutional linkages had been more conducive. An analysis of the economic and political circumstances under which policy-making took place showed, however, that this was highly improbable. In fact, as had occurred in the analysis of the pharmaceutical sector, such an analysis turned out to be of critical importance for an explanation of the political influence that the six banks were capable of exerting.

With regard to regulatory reforms, the circumstances in Germany and Switzerland were largely identical. First, in contrast to many policy areas in the pharmaceutical sector, there was a significant element of congruence between bank's preferences and those of the state. It was noted that with the increasing internationalisation of financial services, regulators in both countries developed an interest of their own to increase the stability of domestic financial systems by bringing regulatory and supervisory standards in line with international norms and standards. Second, policy-making was free from interest group pressure since the issue did not have an impact on employment or income distribution. Moreover, banking regulations are of a highly technical nature and did not generate much public interest. As a result, policy-making remained confined to a relatively small group of technocrats from the federal regulatory agencies and the banking community. Finally, the six banks' internationalisation process was a source of considerable political influence in this policy area since much of the banks' securities business was highly mobile and could be relatively easily shifted between financial centres.

However, circumstances were not always so favourable for the German and Swiss banks. In fact, with regard to the issue of state-sanctioned privileges for public sector banks (in Germany) and the banking conventions (in Switzerland), the circumstances under which policy-making took place were considerably less advantageous. Essentially the factors that were behind the six banks' political defeats in these policy areas were similar to those that were behind the six pharmaceutical MNEs' defeat with regard to health care policy: strong

opposition from the government and other organised interests and an inability to use internationalisation as a source of political leverage. In the German case, domestic opposition came from the *Länder* governments, on whose support the government often depends, and the *Association of Public Sector Banks*. In the Swiss case, it came predominantly from the government, which was determined to adjust the Swiss regulatory framework to international best practices.

In short, as was the case in the pharmaceutical sector, interest- and institutions-based explanations provided a useful starting point for an explanation of the six banks' political influence. However, both approaches left many questions unanswered, and supplementing these approaches with an analysis of economic and political circumstances turned out to be of significant importance.

Finally, this study also analysed the political strategies and influence of the 12 MNEs at the European level of policy-making. It was pointed out that again the main differences were not between MNEs from Germany and Switzerland, but rather between pharmaceutical MNEs and banks. While the six pharmaceutical MNEs were highly active at the EU level, the six banks continued to centre their political strategies at the national level – at least until 1995. It was shown that although Switzerland was not a member of the EU, the Swiss pharmaceutical MNEs were politically just as active as their German counterparts.

With regard to policy outcomes, the picture for the six pharmaceutical MNEs was, on balance, brighter at the European level than at the national level. It was shown that despite initial problems in the area of biotechnology regulations, the European associations of the pharmaceutical industry - *EfPIA* and *SAGB* – managed to build up institutionalised relationships with the European Commission. Chapter 7 pointed out that a number of authors had argued that by virtue of these relationships, the European pharmaceutical industry had managed to secure favourable policy outcomes with regard to biotechnology regulations, intellectual property rights and marketing directives. Moreover, it was shown that the most significant defeat of the European pharmaceutical industry in recent years – the rejection of a directive for the patenting of biotechnological inventions – could be linked to a decision-making process that involved the European Parliament, the "natural home" of environmental and consumer interest groups. In other words, institutional explanations went a long way towards explaining the political influence of the pharmaceutical MNEs at the European level of policy-making.

In the European banking sector, policy outcomes were even more favourable. Chapter 7 noted that the GATS Agreement for Financial Services and EU liberalisation measures within

the context of the SEA largely corresponded to the six banks' preferences. Although banks complained that both policy initiatives did not go far enough, they were clearly a step in the right direction. However, as already noted, both the German and the Swiss banks were largely uninvolved in policy-making processes at the European level and continued to centre their political activities at the national level (at least until 1995).

In short, the analysis has clearly shown that interests and institutions were important for an explanation of MNEs' political influence. However, in many cases these explanations were not sufficient by themselves. It was shown that economic and political circumstances often significantly affected the political influence of the 12 MNEs. Hence this study's argument for an explanatory framework that went beyond interests and institutions appears perfectly justifiable. Certainly one might regret the loss of parsimony. However, parsimony is not the only criteria by which a theory is judged. There is also explanatory power and range – and while the proposed framework may not have scored a lot of points on the first criterion, it scored considerably on the second and the third.

## All Ad Hoc?

While the proposed explanations of MNEs' preferences and political influence appear to sound plausible, a question remains as to whether they are essentially all ad hoc in nature or whether there are any broader conclusions that can be drawn. Indeed, from a review of the principal findings, it appears possible to deduce a number of testable propositions. Naturally they should be treated with caution since they are only based on the evidence from 12 MNEs, two sectors and two countries.

With regard to MNEs' preferences, there are four propositions that can be made. *First*, the finding that all three German MNEs strongly advocated measures to segment EU health care markets along national lines in order to prevent parallel imports suggests that the explanatory logic that explains MNEs' trade policy preferences as the result of the extent and nature of their internationalisation process is not as water-tight as the literature reviewed in Chapter 1 seems to suggest. After all, these MNEs are by all standards highly internationalised companies, and yet all of them supported measures that could be interpreted as protectionist.

*Second*, the argument that a business focus on innovation gave the six pharmaceutical MNEs a strong interest in competition-promoting health care policies might be applicable beyond the pharmaceutical industry. There appears to be no obvious reason why the

assumption that, given free choice, consumers are unlikely to select second-best products should only be valid for the pharmaceutical industry. In fact, it appears to make sense for every company that is in the business of developing products that are superior to existing ones to support *public policies* that aim to establish open markets<sup>1</sup>. This hypothesis depends, however, strongly on the view one takes about the effects of intellectual property rights on the functioning of competition (see Chapter 3) since, as will be argued below, companies that are in the business of developing innovative products are also likely to be strong advocates of a maximum of intellectual property protection (particularly when R&D expenditure is substantial).

*Third*, the observation that a focus on research-intensive drugs that can be easily replicated was behind the six pharmaceutical MNEs' strong preference for the protection of intellectual property is also likely to be applicable beyond the pharmaceutical industry. It seems self-evident that companies, which invest huge sums in the development of innovative and easily replicated products are always likely to support policies that provide for a maximum of intellectual property protection (e.g. computer software, films, music, etc.).

*Fourth*, the analysis of the six banks' policy preferences showed that an important factor behind their preference for open international markets was the fact that the important bits of the investment banking and asset management business were clustered in a few financial centres. Quite conceivably the existence of clusters might have the same effect in other sectors. It appears only natural for a company whose production process is irrevocably tied to a certain location to support open international markets, since cross-border exchange is, under such circumstances, the only feasible strategy to serve foreign markets.

Turning now to MNEs' political influence, there appear to be two testable propositions that can be deduced from the analysis. *First*, when the threat to move production abroad was credible and was directly linked to the policy issue at hand, *internationalisation* was indeed a considerable source of political leverage for the 12 MNEs. In the pharmaceutical sector, for example, MNEs' increasing internationalisation of R&D activities was an important factor behind their relative "success" of preventing the government from giving in to populist demands for stringent and comprehensive biotechnology regulations. In fact, the difference that internationalisation can make for MNEs' political leverage was particularly visible in the case of the German pharmaceutical industry. In 1990, when the three MNEs were only just

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<sup>1</sup> The recent anti trust case against Microsoft suggests, however, that matters can be very different when it comes to MNEs' business strategies.

beginning to internationalise their R&D activities, the government ratified the highly disadvantageous *Gene Technology Act*. Only three years later, however, amid fears of a hollowing out of the German research location, the government significantly reformed this act. Similarly, in the financial services sector, banks' internationalisation process was a source of political influence when it came to reforms of domestic regulatory frameworks.

Certainly this proposition might not come as too big a surprise, since it is widely assumed that globalisation has turned MNEs into powerful political entities. What was surprising, however, was that in a number of policy areas in both sectors, MNEs' internationalisation was *not* a source of political influence. In the pharmaceutical sector, for example, MNEs' internationalisation process did not give them political leverage with regard to health care reforms. Similarly in the financial services sector, the increasing internationalisation of the German banks did not help them with their preference for a level playing field between commercial and public sector banks, and neither did the increasing internationalisation of the Swiss banks make a difference regarding the government's decision to abolish the Swiss banking conventions. In all these cases, there was no direct link between the policy issue at hand and MNEs' internationalisation process, and hence the threat to shift production abroad was simply not credible. In short, while the argument that internationalisation can be a source of political influence for MNEs is certainly valid, the precise extent of political leverage that can be derived from cross-border production networks varied considerably across policy areas.

The *second* observable pattern behind variations in MNEs' political influence centred on the *nature of policy issues* and the *composition of policy-making communities*: whenever a policy issue was of a technical nature and did not attract popular scrutiny, MNEs were able to exert considerable political influence. If, however, the policy issue involved other domestic groups and stirred popular emotions, MNEs invariably faced an uphill struggle in their attempts to shape policies according to their preferences and, most of the time, had to settle for policy outcomes that were far from their preferences. This phenomenon was visible in both the financial services and pharmaceutical sector.

It was noted that the six banks were considerably influential with regard to reforms of domestic regulatory frameworks - policy issues that did not attract much popular attention since they were neutral in their effect on employment and income distribution and did not affect any larger societal concerns such as health or safety concerns. It was also observed that in both countries policy-making processes in this issue area had remained confined to elite groups and were free of the politicisation that was so conspicuous in other issue areas. In

contrast, when policy issues had a populist appeal and involved other organised interests - as in the case of the state-sanctioned privileges for German public sector banks and the Swiss banking conventions - banks were much less influential. A similar pattern could be observed in the pharmaceutical sector at the European level. With regard to technical issues that did not attract popular scrutiny - e.g. patent restoration terms, grace periods or directives for the marketing of drugs - policy outcomes closely corresponded to MNEs' preferences, while in policy issues that attracted popular attention MNEs were a lot less influential, e.g. patents on biotechnology inventions.

German and Swiss biotechnology regulations are an interesting case in this context. This is an issue area in which MNEs' internationalisation process should be expected to give them extra political leverage, yet as the last section suggests, MNEs' political influence was likely to be held in check as a result of the high levels of politicisation that were surrounding this policy area. In both countries, these dynamics manifested themselves in essentially similar terms: nominally MNEs were relatively successful in preventing stringent and comprehensive regulations. Chapter 5 noted that the revision of Germany's *Gene Technology Act* and Switzerland's new regulatory framework were not too unfavourable. At the same time, however, as a result of the activities of organised interest groups, the interpretation and application of these regulations turned out to be a very different matter; in both countries MNEs complained about delays and arbitrary interpretations.

It is this last scenario that might provide a glimpse of the future, since it involves the interaction of two defining trends of the last decade. On the one hand, the number of MNEs has increased strongly and these companies have begun to internationalise an ever growing array of production and managerial activities in order to tap the knowledge potential of various countries, exploit regulatory differences and design production processes in which each element is carried out in the best suited location. Market efficiency is paramount for such companies and as a result of the increasing complexity of their international production networks, many business segments can be relatively easily shifted between different production locations. Hence the "threat" to move production abroad has become real in an increasing number of policy areas. On the other hand, the last decade has also seen the emergence anti-market ideas and causes that have gained support from a number of developments. Examples include the growing influence of environmentalism in forms which involve condemnation of or disregard for market processes or, what Friedman has called, "an excessive drive to equality" manifesting itself in, for example, an ever-widening scope of

labour market regulations or affirmative action programmes<sup>2</sup>. In fact, it appears that a growing number of interest groups share a vision of the world in which market-based economic systems are viewed in terms of patterns of oppression and abuses of power<sup>3</sup>. Taken together these developments have provided a significant counter force against the demands for greater market efficiency from MNEs. It does not seem far fetched to suggest that the next decade will witness a clash of these two broad developments on more than one or two occasions. The concrete forms and shapes of these conflicts are likely to be the topic of numerous studies to come.

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<sup>2</sup> Quoted in Henderson (1998), p. 88.

<sup>3</sup> For a more detailed analysis of these developments see Henderson (1998), pp. 88ff.

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Prof. Dr. Niklaus Blattner	Chief Economist, Swiss Bankers' Association
Beat Brenner	Co-ordinator, Neue Zürcher Zeitung
Dr. Wolfgang Brühl	Division Head for Economic and Market Research, Hoechst AG
Dr. Ernst Buser	Division Head for Economic Affairs, Novartis AG
Thomas Cueni	General Secretary, Interpharma
Peter Dietlmaier	Director, Goldman Sachs & Co
Prof. Dr. Hans Geiger	Institute for Swiss Banking, University of Zürich
Dr. Gustav Grisard	Executive Chairman Hiag Holding AG and Vice President, Vorort
Dr. Robert Geursen	Vice President, Hoechst Marion Roussel
Dr. Remo Glaser	Division Head for Nutrition Research, F.Hoffmann-La Roche AG
Dr. S. Gross	Division Head for Banking Supervision, Bundesverband deutscher Banken
Dr. Hans Joachim Hass	Division Head for Economic Policy, Bundesverband der Deutschen Industrie (BDI)
Gerd Hauth	Division Head for International Economic Affairs, Bayer AG
Dr. Steffen Hoffmann	Secretary, Swiss Bankers' Association
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Dieter Herd	Editor, Börsenzeitung

Heinz Hertig	Division Head, Bundesamt für Aussenwirtschaft
Daniel Hofmann	Neue Zürcher Zeitung
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Ulrich Pfister	Director, Credit Suisse
Ulrich Ramm	Chief Economist, Commerzbank
Cesare Ravara	Senior Economist, Credit Suisse
Dr. Peter Rogge	Economic Consultant and former Director, SBC
Dr. Martin Rissmann	Division for Corporate Communications, BASF AG
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Dr. Fritz Stahel	Chief Economist, Credit Suisse
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Dr. Rudolf Walser	Permanent Secretary, Vorort
Prof. Dr. Norbert Walter	Chief Economist, Deutsche Bank
Jörg Wolz	Division Head for Trade Policy, Bayer AG