Transforming the Welfare State

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SURVIVING GLOBALIZATION?

Surviving Globalization?

Perspectives for the German Economic Model

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The Editors

Chapter 1

STEFAN BECK, FRANK KLOBES & CHRISTOPH SCHERRER

INTRODUCTION

When the red-green government and Chancellor Gerhard Schröder came to power in 1998, the future of the German economy seemed very clear. The pressures of *globalization* and the success of the *New Economy* gave rise to the conviction, even among Social Democrats, that the institutional structure of the German economy would have to be "modernized" in a way that would strengthen the forces of (new) markets and at the same time weaken its corporatist structure. The predominant model for such a market-style economy was the U.S. economy. In the mid-1990s, propelled by the "New Economy" and the evolution and diffusion of information technologies, a growth pattern emerged in the United States that translated into an unexpectedly long period of economic prosperity, advancing the American Model internationally as a benchmark for economic development.

In Germany, a clear econopolitical and institutional convergence with the U.S. was seen increasingly as the only sure path out of its economic quagmire, leading to international competitiveness. Even if the Social Democratic modernization plan was not a radical one, it nevertheless gave the impression that the once admired, corporatistically regulated German Model (*Modell Deutschland*) could finally be laid to rest for its lack of flexibility and dynamism. Consequently, the red-green government soon moved forward with a reform line that entailed some profound institutional changes to *Modell Deutschland*.

The New Economy's luster gradually faded and, after the first four years of the red-green government, the economic success of Social Democratic supply-side corporatism (*Angebotskorporatismus*) was very much smaller than promised. Achieving the two major goals of budgetary consolidation and reducing mass unemployment by means of extensive tax breaks and the strengthening of (financial) capital is only – if at all – possible in times of economic prosperity. Consequently, for many observers it was no surprise that the red-green government failed in these goals. But what is far more controversial is the question whether a continuation of this policy will turn out to be more successful in the end, or will it undermine the comparative institutional advantages of the German economy.

Where will the journey take us? Will market-oriented reforms in the tradition of Anglo-American capitalism still attract followers after the return to normality? And even if the U.S. economy were to resume a growth course, there's still the question of whether its growth pattern can be generalized and transferred. The assumption of

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a differentiated and path-dependent development of *Rhenish Capitalism* has surely gained in persuasive force; however, the reach and the long-term consequences of contemporary institutional changes in *Modell Deutschland* raise the question of the model's future.

In this book we want to investigate the economic and institutional perspectives of Germany in the context of globalization. The proceeding integration of the global economy not only constitutes the framework conditions for an open economy but also gives incentives for the restructuring of branches, firms, and social institutions. We look at important trends and institutional alterations of the German Model; for example, the reorganization of production systems and labor relations, the restructuring of financial markets and the banking sector, the rising pressure on the welfare state, and the growing influence of the European Union in economic policymaking. But globalization and international trends do not determine the economic and institutional future of an economy. What are also important are the reactions and strategies of political and economic actors, which are embedded in and influenced by their historically and spatially defined institutional context. Accordingly, our focus is not on globalization itself but on the articulation of various developments in this specific context and their interpretation by political and economic actors. The various contributions highlight turning points and contemporary trends for selected structural features of the German Model. They are embedded in a general discourse about the German Model, its "challenges", and the most recent attempts of reforms, which will be outlined in the following.

1. *MODELL DEUTSCHLAND*: SOCIETAL REALITY AND SOCIAL SCIENCE DISCOURSE

In the 1976 election year in Germany, then chancellor Helmut Schmidt held up *Modell Deutschland* to his European neighbors as a remedy for the fallout of the 1970s economic crisis. Little did he know that he delivered the catchword for a social science discourse that continues to this day. The term *Modell Deutschland* became the focus of social science debates that contested the normative and analytical definitions of "German Capitalism". A look at the number and frequency of publications on the "German Model" reveals a publishing boom in the early 1980s and again in the late 1990s. Both times coincided with changes of political administrations, and both times – for different political reasons – fundamental changes were in the works. While in the early 1980s *Modell Deutschland* stood for a successful crisis regulation model (Esser et al., 1983), at the end of the 20th century its institutional structures were themselves mired in crisis (Streeck, 1999).

Both domestically and internationally, the German Model was often associated with the successful marriage between international competitiveness and social consensus. On the one hand, these two factors attested to a high integrating power of the system of political institutions, and on the other, to the German economy's highly successful competitive position on the world market. Endeavors to pinpoint the heart of the German Model inevitably target the interfaces between market, society, and state (Streeck, 1999; Simonis, 1998). Interspersed between these most commonly named elements are the following:

First, the high political integrating force of the German Model after WWII was based on the adoption and transformation of corporatist political structures from National Socialist Germany. Liberal capitalism was (re)introduced under political competition between Christian Democrats and Social Democrats, who eventually found common ground in the politically mediated compromise between capital and labor: "This compromise was negotiated and institutionalized at a time when the communist wing of the workers movement and the authoritarian voices of German capital – for various reasons – were excluded from political participation" (Streeck, 1999, p. 15; translation: SB).

The partnership between firms and unions manifested itself in manifold institutional structures. Apart from the social partners' autonomy in matters of wage policy, worker codetermination at plant level and in operations is regarded as one of the special achievements of the German Model and has contributed substantially to social peace. The political coordination forms of concerted action, round tables, as well as modernization and crisis cartels gave birth to a highly complex political decision-making structure which, based on a federalist setup, has rightly been called "negotiation state" (Esser, 1998, p. 123).

Second, the material foundation of this "Social Democratic class compromise" (Buci-Glucksmann & Therborn, 1981) consisted in the Federal Republic's – in the words of Göste Esping-Andersen – "conservative-liberal" form of welfare state. Amid the economic prosperity and full employment growth of the post-war period, this Bismarck-style social state served as social insurance against the (income) risk of joblessness, financed solidaristically and equitably by capital and labor. Hence to a certain extent the German welfare state is the continuation of the class compromise between capital and labor at the social policy level.

Third, besides the negotiation state and the welfare state, the German Model was characterized by a relatively large cooperative economic sector. Nested primarily in the communal area, its task has always been to ensure that the Federal Republic's constitutionally enshrined equality of living conditions is met in those areas where profit-oriented companies hesitate to venture. Its activities crystallized in the transportation and energy sectors, but also in the financial sphere (thrift institutions and agricultural credit cooperatives) and in regional cultural policy.

Fourth, Modell Deutschland's financial system was dominated by large banks engaged in industrial policy, while regionally oriented small and medium-sized businesses capitalized on communally oriented cooperative credit institutes. This peculiar linkage between bank capital and industry capital via cross participations and credit financings of industrial projects is what made German industry competitive and let *Deutschland AG* enjoy constant export surpluses, thanks also to the *Bundesbank*'s stability-oriented monetary policy (Voy & Herr, 1989). The German all-purpose banking system played an important role in the industry-political self-organization of German employers, which together with public and state-owned research and technology institutes made up the technological heart of the German Model (*national innovation system*; Becker & Vitols, 1997).

Fifth, the German economy's organizational structure is naturally affected by corporatist policy structures as well. Corporatism requires strong self-organization on the part of capital in order to better mediate capital interests and political demands. Central associations of the corporate world as well as more regionally oriented chambers of industry and commerce and of handicrafts are the institutional junctions that make possible this interest-oriented self-organization.

Sixth, the (West) German economic structure is dominated by an export-oriented core sector of mostly large firms. The so-called *diversified quality production* is characterized by high productivity increases, high quality and high wages. Its institutional base is made up of a strong and highly adaptive innovation system, the collaborative system of vocational training and education, and the dual system of industrial relations. The investment goods industry (machine and plant engineering, automotives, chemicals, electronics, and steel) is what gives German business its (inter)national competitive edge (Esser, 1998, p. 123).

These institutional and structural features of the German Model were embedded in an economic phase dubbed the "golden age of capitalism" (Marglin & Schor, 1990). The restitution of the world market by the U.S. and American capital expansion gave shape to a transatlantic growth constellation that allowed Germany with its neo-mercantilist export policy to take advantage of the U.S. wars in Korea and Vietnam. High growth rates, full employment, and a growing body of social policies created a "dream of perpetual prosperity" in Germany (Burkhart Lutz). But with the economic crisis in the 1970s the "golden age" ended. Prosperity gave way to unemployment and economic restructuring. The ensuing large-scale joblessness revealed the relative rigidity of incomes and of the German welfare state as a problem. Especially non-traditional work and earning forms, which affect women in particular, increasingly fell victim to structural disadvantages (Ostner, 1998). In the framework of world market-mediated crisis processes, the German Model was now transfigured into a crisis regulation model, which became less and less inclusive; the term "selective corporatism" was born:

> "The combined economic interests resulting from the new world market pressures have forged world market-oriented capital, state, and unions into a corporatist block, which has collectively endeavored to advance the modernization of the national economy to ensure international competitive ability and at the same time to permanently exclude those groups that do not fit into the functional logic of this world market" (Esser, 1998, p. 125; translation: SB).

As the Kohl government came to power in 1982, many observers predicted profound changes to the German political economy in the direction of the market-oriented, deregulatory, anti-union policies pursued by Great Britain and the United States. The center-right government, for example, introduced cuts to welfare state benefits, linked them to stricter conditions, curbed unions' right to strike, and pressed ahead with deregulation and the privatization of public enterprises. At the same time, industrial restructuring was accompanied by an increase in non-standardized employment, a reduced commitment to wage agreements, and a long-term decline of the wage ratio. All in all, market-oriented and deregulatory policies were clearly less pronounced in Germany than in some other countries or failed because of the resistance of unions and the political opposition. Counter to the predictions, the institutional structure of the German Model remained quite stable – at least until German reunification (Allen, 1997; Upchurch, 2000).

On 1 July 1990, the currency union confronted the East German economy "overnight" with the conditions and restrictions of the world market represented by the strong West German Deutsche Mark (DM). Moreover, the overvaluation of the capital stock and the modes of exchange considerably raised East German firms' debts (cf. Altvater, 2001; Hölscher & Stephan, 1998). Consequently, competitiveness of the East German economy dropped drastically and exports to former Comecon countries fell by more than 75% between 1989 and 1992. October 3, 1990, marked the formal "incorporation" (*Beitritt*) of the German Democratic Republic into the Federal Republic of Germany under Article 23 of the latter's constitution. Subsequently, the entire West German legal and institutional system replaced German Democratic Republic (GDR) institutions nearly one to one (cf. Schulz, 2000). An important reason for the hurried unification was the East German people's strong desire to get quick access to Western "achievements", coinciding with the reelection opportunity for the Kohl government.

Although its basic institutional structures were retained, *Modell Deutschland* experienced a long-term institutional shift coinciding with the collapse of the GDR. In the context of large-scale unemployment and rising social disintegration, the parameters of its institutional arrangement changed. The increasing withdrawal from collective agreements (*Tarifflucht*) and "sector shopping", that is switching to other sectors and renegotiating new collective agreements with other unions, is only one well-known phenomenon (Allen, 1997, p. 77). Sigurt Vitols, researcher at the Wissenschaftszentrum Berlin, pinpointed four structural challenges that put strong pressure on the German Model's institutional structure to adjust (Vitols, 2000, p. 375):

(1) state socialism's decline and concomitant German reunification;

(2) sustained changes to the global production system commencing prior to 1990;

(3) changes in the demographic patterns and in the social values underlying individual and interindividual behavior; and

(4) a qualitative leap forward in the process of European integration.

This list could be extended to include the global financial system that has emerged since the 1960s, which plays a special role as regards future corridors of possible change to the German Model and other national capitalisms (cf. Story, 2000). Increasing economic and political globalization is also inseparable from the scholarly question of how this could affect institutional structures of diverse national forms of capitalism (Kitschelt et al., 1999a). Will the crisis surrounding *Modell Deutschland* that commenced in the 1980s be transformed now into a variant of Anglo-Saxon capitalism?

2. RHENISH CAPITALISM BETWEEN PATH DEPENDENCY AND MODEL CHANGE

If persistent mass unemployment since the 1980s, social disintegration processes, and dwindling growth dynamics are anything to judge by, then the German Model has been mired in crisis for more than two decades now. Particularly in recent years, discussions about overhauling this model have gained in importance and influence. Following the collapse of "real-world socialism", not only did the West claim victory in the system competition, but German reunification silenced all criticism of the West German social and economic systems. After all, at that time it wasn't opportune to criticize an institutional model when it had just come out on top and was to be transferred intact to East Germany (Andretta & Baethge, 1998). And while the West German economy found deliverance in a surge of demand caused by East Germans' pent-up desire for Western consumer goods, the American economy was pitied rather than admired, whether for its record trade deficits or for its evident decline in competitiveness.

This reprieve didn't last long. West Germany was dragged down again by the world business cycle and East Germany's catching-up process came to a near halt in the mid-1990s. It became apparent during East Germany's transformation that its economic difficulties were not solely the legacy of the GDR economy but were also aggravated by the slow growth of the German and the European economies and by institutional incompatibilities caused by ignorance of these legacies and complex interdependencies between institutions (Carlin, 1998). Yet the latter phenomenon was rarely used to question the limits and context of institutional transfer. Instead, "negative feedback effects" put the initial model of welfare state-regulated capitalism under mounting pressure (Andretta & Baethge, 1998; Paqué, 1998).

It takes more than one model's difficulties alone to make another one seem imitation worthy. What really mattered was that economic fortunes switched sides again internationally. Not only did the U.S. economy revive, it soared to new heights thanks to the New Economy. Meanwhile, the German and European economies ("eurosclerosis"), and above all the hitherto impressive Japanese economy, slid into a deep crisis. The similarities between the German and Japanese economic models increasingly became the topic of debate in the second half of the 1990s, which pitted *Asian* and *Rhenish capitalism* on one side, as stronger production and society-oriented economies, and the consumer and market-oriented *Anglo-Saxon capitalism* on the other (cf. Dore, 2000; Weber, 1999). In these comparisons, the latter is frequently attributed higher growth and employment dynamics owing to a more flexible labor market, higher innovation potential in new technologies, and strong corporate orientation to (capital) market success. Critics of the Anglo-American model, however, not only point to rising societal inequality and risks of a "short-term economy", but also challenge the principle of its economic superiority (Kern & Schumann, 1998; Weiss, 1998; Schmitt & Mishel, 2000).

Model comparisons of this kind and attempts to imitate successful practices are not new. In the context of globalization, however, these activities have come to a head. It's no longer just an issue of learning from other countries or societies, but a question of whether the adoption of so-called "best practices" is compulsory or even unavoidable and whether this leads to a convergence of institutions and national models. Heightened competition resulting from the liberalization and integration of world markets compels not only firms but also nation states and societies to adapt to the most efficient solutions (cf. Ohmae, 1990; Caspers, 1999). This thesis is countered in now widespread debates with the persistent dissimilarities (*diversity* or *divergence*) between different institutional systems and national models (cf. Kitschelt et al., 1999b; Berger et al., 2001). First, the thesis of compulsory convergence, which follows foremost in the tradition of (neo-classical) economic theory, is faced with the difficulty of explaining – analogous to the convergence of prices – the actual convergence of institutions. Second, the possibilities of adopting *best practices* are limited by institutional *path dependency* and, because of the relevance of *comparative institutional advantages,* convergence is frequently not even desirable (Kern & Schumann, 1998; Soskice, 1999; Hall, 1997).

The question of a model's adoption or adaptation is thus at the same time a question of the possibilities and limits of institutional transfer. The thesis of path-dependent development implies that institutional changes are not open-ended but to a certain extent restricted or affected – though never determined – by previous events and the historical and spatial context thus engendered that are "embedded" in the institutions. Institutions "govern" social relations, which individual actors use to relate to society, and hence are not independent of the actors' *procedural* and *implicit* (not explicable) knowledge. Even if institutions undergo formal changes, this doesn't guarantee practical action and the desired effects (cf. Kogut, 1997; Andretta & Baethge, 1998). And because institutions are embedded in an (institutional) arrangement where they are interrelated, the transfer of individual institutions is not only associated with coordination or compatibility problems but also with countless unforeseeable interactions and causalities. There is no guarantee, for example, that the introduction of new or foreign labor (market) policies will produce desired effects rather than unintended side effects (ibid.; Hancké & Callaghan, 1999; Amable, 1999). Changes to individual institutions, as well as institutional transfer from one economic model to another, thus have more or less serious consequences for the functionality and the specific strengths and weaknesses of the entire institutional arrangement.

In light of the issues touched on above, the institutional development of Rhenish capitalism remains a topical subject. Questions about whether an adaptation of the Anglo-Saxon model (still) appears likely, practicable, or desirable and which institutions could in fact serve as models provide the background for this book. But apart from this discussion, there's also the question of how (long) to defend a German Model that seems less and less able to fulfill its social program and becomes more and more exclusive regarding social and economic benefits (e.g. employment) as well as the opportunities for actors to exit from their societal and economic involvement (e.g. taxes). Therefore, the limits to institutional transfer described here should not exclude institutional learning.

3. THE DESIGN OF THIS BOOK

This book investigates the current shape and imminent developments of the German economy within the discursive framework of *Modell Deutschland*. In addition to illustrating the model's many peculiarities, we aimed to provide a theoretically informed and critical analysis of the German economy and its institutional structure and embeddedness, for example, the welfare state or industrial relations. Furthermore, we discuss current efforts of economic restructuring as well as the endeavors of the red-green government to overcome the "reform deadlock".

Although we would locate our book in the wider context of the debate on different models of capitalism (e.g. Kitschelt et al., 1999a; Hall & Soskice, 2001), the numerous contributions found herein were not motivated by common theoretical deliberations. Rather, they sprang from the intention to identify and discuss the most important trends affecting the German economy and its institutional configuration. On the basis of institutional and heterodox economic thinking, we want to provide an alternative assessment of the German economy and scrutinize the "certainties" of economic mainstream analysis and of the picture of the German economy that is commonly disseminated by the mass media. Therefore, international comparisons and the question of convergence or divergence are not at the center of our analysis. Likewise, the discussion of the Anglo-Saxon variant of capitalism is limited to its function and fitness as a model for restructuring purposes and for the alteration or transfer of institutions.

The latter aspect of institutional transfer and transnational learning is analyzed theoretically by *Christoph Scherrer* in the second chapter. His discussion of the two poles of the debate – the enforcement of *one best way* and the prevalence of *path dependency* – shows that the prevailing theories cannot explain sufficiently the processes of institutional change nor decide the question of competitive convergence or divergence. By using a discourse-analytical approach, however, and taking power relations into account, one can gain more insight into the processes and conditions of institutional transfer. In the end, beyond important factors such as the role of elites, the distribution of power and the work of persuasion, contingency cannot be extracted from the process of institutional change. Also, there remains room for a multiplicity of possible institutional configurations between the adoption of "one best way" on the one hand and the dominance of path dependency on the other.

Nevertheless, in public debates as well as in the academic world of mainstream economics, market-style institutions are often treated as the one best way. Consequently, liberal market economies like the Anglo-Saxon brand of capitalism serve as a model for the "modernization" of non-liberal or coordinated economies. Particularly in the case of Germany, an institutional "incrustration" of the labor market and incentives of the welfare state that are not in line with market requirements are held responsible for high unemployment and poor growth dynamics. In the third chapter, *Stefan Beck* discusses this microeconomic assessment of the German economy and the question of an exhaustion of the German Model with regard to its growth and employment capacities. Since neither the incrustration thesis nor the allegation of lost competitiveness can convincingly explain the current macroeconomic weakness of the German economy, he presents a different explanatory framework based on a Post-Keynesian interpretation of Germany's strong export orientation. According to this analysis, the faded macroeconomic pay off of this "mercantilist instinct" (Herr, 1994) in the context of an altered global economy can explain the German constellation of comparatively high competitiveness, sluggish growth and high unemployment. Consequently, current reform proposals and the endeavors of the red-green government to deregulate the labor market, which further increase competitiveness and prune the welfare state, probably do not help to reduce unemployment but rather impel the deconstruction of the German Model and its underlying social consensus.

The argument that the thesis of reform deadlock and incrustration of the German Model is exaggerated or even misleading is illustrated in the chapters that follow. In several socioeconomic spheres, considerable institutional and organizational dynamics are visible in spite of macroeconomic stagnation. In the 1990s, a major wave of industrial restructuring occurred in reaction to increased international competition. Starting at the sectoral and enterprise level, in chapter four *Frank Klobes* outlines the dynamics of global industrial restructuring and its articulation in Germany. Using the examples of important internationally operating sectors, in particular the automotive, electronics and communications industries, he shows how globalization processes and the evolution of digital technologies propel changes to the governance of branches, value-added chains and work organization. These trends not only reshape business strategies and the international division of labor, but also influence the relations between suppliers and customers and between capital and labor. The latter is mainly a result of the shift from a traditionally German stakeholder value orientation toward a shareholder value orientation driven by the financial market. Consequently, industrial relations are undergoing radical changes, putting increasing pressure on the German dual system of workers representation, trade unions and codetermination at company level. This also challenges the works council's bargaining autonomy and traditional role as a protector of workers' rights, as it is now more involved in company restructuring processes than ever before.

The changes between capital and labor are of special interest for the German Model because the system of industrial or labor relations is one of its core features. In the course of globalization and industrial restructuring, German industrial relations come under pressure from two fronts: On one side, the globalization of business strategies and value-added chains effectively undermines the functional capacities and the inclusiveness of existing regulations. On the other side, several institutions, such as codetermination and sectoral wage bargaining agreements, are seen as a hindrance to the need for flexibility and adaptability in a globalized economy. Against the background of these developments, *Michael Fichter* reviews the German Model of industrial relations in the fifth chapter. He explores its recent alterations, current problems and perspectives under the impact of national, European and international changes. The difficulties that collective regulations faced during the New Economy were symptomatic, as was the recent defeat of the metalworkers' union, IG Metall, in eastern Germany. However, despite the declining membership in unions and employers' associations, Fichter points out that it isn't so much the forces of "erosion" but the strategies and power of employers, unions and government as organized actors that will determine the future course of change.

In chapter six, *Christian Kellermann* examines a further characteristic of the German economy that recently made headlines. Since the end of the 1990s, the close-knit relationship between industry and banks – typical for Germany and often referred to as *Deutschland AG* – came under mounting pressure. In the 1990s, bank and industrial capital started to disintegrate because of commercial banks' new focus on investment banking and corporations' recourse to (international) financial markets. As financial markets gain in importance, the idea and strategy of s*hareholder value* has assumed a prominent position in *corporate governance*. Legislative innovations and the deepening of the German finance sector inscribe shareholder value's central role in the German economy. However, the focus on shareholder value undermines the German mode of corporate governance, which is a vital feature of the German Model. The liberalization of *Deutschland AG's* corporate governance institutions will promote the convergence with prevailing Anglo-American practices. Furthermore, the influence of shareholder value on the disentanglement of *Deutschland AG* will continue, since the processes of enhancing the importance of financial markets and its main players, institutional investors, have just begun. As Kellermann points out, today's talk about Germany's economic health is no longer about the industrial might of *Deutschland AG*; it is about *Finanzplatz Deutschland*.

The structural challenges of globalization, mass unemployment, and demographic shift have also reinforced debates about the future of the German welfare state, which is financed by social security contributions and tax revenues. In particular, unemployment, atypical employment relationships, and discontinuous work biographies contribute to the difficulties of social security systems. In chapter seven, *Kai Mosebach* discusses recent reforms of the social insurance system and the labor market with regard to their impact on the German Model of welfare capitalism. Contrary to the prevalent assumptions of a reform deadlock or a governing crisis, he shows that the red-green government has already initiated considerable changes to some basic institutions and to their functional logic. The question is whether a subordination of the welfare state to the demands of economic competitiveness and individual accountability can remedy the causes of the underlying social and economic problems.

In chapter eight, *Kai Mosebach* first examines the consequences of globalization and international capital mobility for national taxation. He then discusses the tax and fiscal policies of Chancellor Schröder's coalition government. As his analysis shows, after the early exit of finance minister Lafontaine, the tax policies of the Social Democratic and Green coalition rested on two questionable presumptions: First, the assumption of inevitable erosion of the tax base (as a consequence of capital mobility and international tax competition) is built on fragile theoretical and empirical ground; second, looking at effective tax rates, the thesis of "high-tax country Germany" lacked empirical evidence even before the red-green business tax reform. Furthermore, the government made fiscal consolidation in accordance with the European Stability Pact its primary objective. In contrast to the effects on growth and employment hoped for, however, the results of this policy have been problematic so far. In a time of economic recession, the combination of tax cuts and fiscal consolidation efforts have had detrimental effects on tax revenues and public investments. Moreover, the pro-cyclical character of these policies has counteracted the aim of reducing public debts. The use of tax policy as an instrument to enhance competitiveness and to attract capital may end up being the driving force behind destructive international tax competition rather than a necessary consequence of it.

The possibilities of tax evasion and the threat of international tax competition highlight the growing importance of international or macro-regional coordination. Theoretically, the project of European integration could offer the opportunity to compensate for lost regulatory capacities of nation states on a supranational level. However, regional integration could also be driven by other objectives, foremost the liberalization of transnational (economic) activities and – as in the case of the European Union – finally the creation of a common market. In this case, national regulations are abolished and competences transferred to the supra- or international level. In chapter nine, *Gülay Çağlar* discusses European integration and its impact on the German regulatory regime and specific institutions, in particular codetermination and collective bargaining. Since the mid-1980s, European economic integration has been driven by two goals: the enhancement of intra-European competition and the strengthening of European enterprises' competitiveness. Therefore, national regulations, for example, concerning network industries or services, have been abolished and the possibilities to grant subsidies or state aid have been restricted. However, since European industrial policy furthers – or at least tolerates – concentration processes on a European scale, the relationship of both goals (competition and competitiveness) is not free of tensions. In consequence, the configuration of the German Model is weakened not only by reduced room for maneuver in industrial and regional policy, but also by the process of European concentration, which encourages the disentanglement of *Deutschland AG*.

Less clear are the effects of the European Monetary Union on collective bargaining and wage-setting behavior in Germany. While some neo-classical economists anticipate a trend toward higher nominal wages as a consequence of the spatial difference between the (European) currency area and (national) wage bargaining, other researchers highlight the disciplinary forces of European competition. Thus far, empirical evidence tends to support the latter thesis.

As with national economic policies, the course of European integration and the European Union's influence on economic and social policy do not go undisputed. "Traditional" Social Democrats or heterodox economists in particular promote a rather Keynesian or coordinated macroeconomic policy, which should be supported by an amenable European monetary policy, coordination of tax policies and less restrictive regulations of fiscal policy. In Germany, this position was advocated by Oskar Lafontaine, the former Social Democratic Party leader and finance minister for the "first phase" of the red-green government that came to power in 1998. After the sudden resignation of Lafontaine, however, the red-green government under the lead of Chancellor Gerhard Schröder changed its course toward a supply-side and more business-friendly economic policy. Despite growing dissatisfaction among the traditional Social Democratic base about the dismantling of the German welfare state, Schröder's government has stayed this course. In chapter ten, *Stefan Beck* and *Christoph Scherrer* illustrate the shifts in red-green economic policy and examine the socioeconomic and institutional consequences for the German Model and – even more interesting – the political and strategic reasons behind these shifts.

Compiling the findings of the varied contributions, in the concluding chapter we will again take up the question of the German Model's prospects for *surviving globalization*, with special regard to three features: democratic participation, social and material inclusion, and Germany's orientation toward the world market. Despite clear lines of continuity, there are also considerable institutional alterations, functional shifts, and an increased withdrawal of actors from existing regulations and standards. However, current reform endeavors, a declining reliance on previous modes of coordination, and the implementation of market-style regulations cannot be equated with an exhaustion or inevitable decline of the German Model. Its enduring export success and its capacity to cope with the huge and problematic task of reunification are indicative of the lasting strengths of the model. Nevertheless, the German Model seems to be at a crossroads now, and its future is interwoven with the future course of European integration.

Stefan Beck is a research assistant and Ph.D. candidate at the University of Kassel, Germany. His research is about the economic perspectives of East Germany in the context of globalization. Frank Klobes did his Ph.D. thesis at the works council of Volkswagen Corp., Kassel, on "International Division of Labor and Strategies of Integration". He is currently working in human resources management at Volkswagen Corp. Christoph Scherrer is Professor of "Globalization & Politics" at the University of Kassel, Germany.

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Chapter 2

CHRISTOPH SCHERRER

CAN GERMANY LEARN FROM THE USA?

Some Theoretical Observations

1. INTRODUCTION

In this book, chapter for chapter we will trace the recent introduction of Anglo-Saxon-styled market mechanisms to the *Modell Deutschland*. Will we have to be modest and restrict ourselves to describing this process or can it be theorized? How does institutional transfer happen and will it work? The debate on the possibilities for institutional transfer, or "learning" from distant practices, was originally motivated by East German and Eastern European transformation processes. But the issue of institutional transfer has been raised not only with respect to the "East" but also with respect to the various national models of mature capitalist societies, that is in the "varieties of capitalism" debate (Hall & Soskice, 2001). In both debates, the terms path dependency and convergence through "natural selection" to "one best way" play a major role, albeit to differing degrees. In transformation discourse, the empirical observation that key political and economic institutions can evolve differently among countries and that these differences are related to the institutional traditions of the respective country has made the term path dependency increasingly attractive from an analytical point of view. In the discourse on competition between different forms of capitalism, the spectacular job growth under the Clinton administration and the deregulation of various product markets in Europe have lent credence to the idea that the Anglo-Saxon brand of capitalism is the "best practice". Path dependency and competitive convergence represent two poles in the spectrum of answers to whether "learning" from other countries is possible. In its purist form, the path dependency thesis implies that a domestic institutional transformation is affected at most slightly by the perception of foreign institutions, and that learning – especially the attempt to implement what has been learned – can take place only in the framework of existing institutions. By contrast, the "one best way" thesis implies that the most efficient practice must be adopted under penalty of ruin.

Which one applies: Divergence owing to path dependency or competitive convergence owing to "one best way"? In this chapter[1] I will aim to show that this question cannot be decided on the basis of currently prevailing theories, particularly

S. Beck, F. Klobes, C. Scherrer (Eds.), Surviving Globalization?, 15—31.

Neoclassical economics and New Institutional Economics, primarily because they inadequately address the "how" of institutional transfer. I will instead outline an explanatory model that enriches the key insights of New Institutional Economics (which can also be traced back to other theories) with the dimensions of discursive strategy and power. The inclusion of these dimensions raises the question of what enables societal actors to convince other relevant actors of the advantages of a foreign model and to initiate the imitation of this model. In the following, this approach will be theoretically underpinned by Chantal Mouffe and Ernesto Laclau's discourse analysis as well as by Gramscian power theory. To avoid misinterpretations, this paper will not take on the entire spectrum of transnational learning, which besides institutions encompasses mainly ideas and individual political measures. Rather, the focal point lies in discussions on the adoption of foreign institutions. First, however, the "one best way" and path dependency theses will be critically considered.

2. THE ONE BEST WAY THESIS

In Neoclassical economic theory, transnational competition leads to factor price harmonization and thus to a process of "one best way". In the long term, only the most efficient production techniques can hold their own on the world market. This line of argumentation has also been applied to the development of economic policy institutions, such as private ownership of the means of production. According to New Institutional Economics pioneer Douglass North, private property rights endured historically because they proved to be the most efficient (North & Thomas, 1973). Today, advocates of this position with a Neoclassical or managerial mind-set (the New Institutional Economics theory has meanwhile dedicated itself to the issue of persistently inefficient institutions; see below) find that, in light of international competition, it is practically an imperative for an individual country not only to facilitate the adoption of the most productive techniques but also to orientate its own economic policy institutions on the most efficient model internationally (Siebert, 1996; Ohmae, 1990; Womack et al., 1990; Bartlett & Ghoshal, 1998). A similar line of argumentation can be found in other theories, for example, in modernization theory (Zapf, 1991) and in Marxism (Brenner, 1999).

The paucity of empirical evidence does not necessarily disprove the theory. The discrepancy between empirical data and theory may be explained on the one hand by the fact that the processes of denationalization (Zürn, 1998) and globalization were nascent. Only in the last few years have these processes made any real headway. Indeed, many observers believe that the process of convergence has recently accelerated. Transnational mergers and capital market liberalization, which lead to similar financial evaluation criteria ("shareholder value"), mean that a greater push toward standardization may be expected in the future (Boyer, 1999, pp. 12-13; Ertman, 1999; Cattero, 1999).

There is much to substantiate a dependency of the scope and speed of convergence on the degree of market growth. While companies from the manufacturing sector are quite directly at the mercy of international competition and are therefore under enormous pressure to conform, most service sector companies are less affected by it and, despite having similar profit-driven efficiency criteria, they can deviate more from the "best practice" ideal without greatly risking their market position.

Yet this insight weakens the postulate of a world market-induced convergence of economic policy institutions. It brings into question how the firms' pressure to conform is transferred to state institutions. The Public Choice approach, in line with this tradition of economic theory, sees competition for political office as the definitive transmission belts. Up to now, however, this approach has mostly been used to show how the creation of economically efficient institutions could be thwarted by interest groups in the electorate (the so-called "principals") and by autonomous politicians (the so-called "agents") (cf. Udehn, 1996, p. 67).[2] Without empirical evidence, one cannot safely say within this theoretical context that the firms' pressure to conform is taken up adequately by politics. The convergence thesis thus lacks the crucial political transmission belt to explain convergence.

But also on the national stage, where markets are the most advanced, divergent corporate cultures may still be found even within the same sector (Dörrenbächer & Wortmann, 1993; Jürgens, 1992). In light of this empirical phenomenon, the Neoclassical theory reveals its failings by focusing on price as the decisive factor in market success. Market success cannot be reduced to the ability to offer goods at low prices (Porter, 1990). There are many other contributing factors, such as reliability, which leave ample maneuvering room for corporate strategies. But even when price is the sole factor in a product's market success, market price can be enforced by myriad combinations of input factors with diverging factor endowment.
The theory, based on an ideal of equilibrium, is moreover little suited to explain innovations. If all companies were oriented on "best practice", innovations would soon come to a standstill. On the one hand, there would be no competitive edge to serve as an incentive to innovation. On the other, the combinations of factors that breed promising innovations would be severely restricted due to the homogeneity of practices. An innovative climate demands that a few firms stand apart from their competitors, with the result that they either will fail sooner or later on the market or will be unexpectedly successful (cf. Hung & Whittington, 1997, p. 553; Bikhchandani et al., 1992).[3]

But assuming that even more sectors were subject to market-economic logic and polities reacted quickly to the demands of their economic subjects, this would not necessarily result in convergence. According to the "theory of *comparative* institutional advantages", as elaborated by David Soskice and his research group at the Wissenschaftszentrum Berlin, economic policy institutions can become specialized in a manner analogous to product specialization. This theory transposes Ricardo's idea of mutual gains from world trade to the institutional level. Just as specialization emerges in traded goods, so too do individual nations undergo a specialization in institutional structure, because the product strategy pursued in each instance requires its own institutional setting. Hence German companies focus on incremental innovation because the German labor law and financial system, among other factors, guarantee the necessary long-term planning horizon. By the same token, American companies use the institutional conditions in the U.S., such as deregulated labor relations and dynamic risk capital markets, to pursue strategies of “more radical innovations”. Therefore, Germany’s adoption of elements of the American model could only be achieved at the cost of the complete dismantling of its models for industry and innovation (Hancké & Callaghan, 1999).

Even where convergence is manifest, the impetus is not perforce the competition mechanism. Uniformity can spring from generalizations in interpretative patterns and from similarities in micropolitical strategy effects (Ortmann, 1995, p. 285; for “coercive isomorphism”, “mimetic processes”, and “normative pressures”, see also DiMaggio & Powell, 1983). In the case of management practices, a series of factors could explain alignment tendencies; for example, intercompany management discourse at the level of trade shows, trade journals, and management consultancy agencies (cf. Strang & Soule, 1998). In other words, the thesis of competition-based convergence must stand up to alternative explanations.

3. PATH DEPENDENCY

In economics, the path dependency concept stems from the attempt to explain the discrepancy between the theoretical assumption of efficient institutional development and the durability of inefficient institutions. The history of technology teaches us that suboptimal technologies can thrive for a relatively long time if they enjoy a head start. The typewriter keyboard is a notable example (Ortmann, 1995, pp. 255-261; David, 1985). For a theory based on a rationally calculating, benefit-maximizing individual, one may well ask how rationally made decisions can engender something so suboptimal. The answer lies in positive network externalities of technologies. These kinds of externalities occur when a technology application’s utility increases with the number of users or consumers. In such a case, the circumstances surrounding the first successful applications are of major significance. Path dependency is strengthened by, first, high start-up investments that lead to falling per-unit costs with increasing output; second, learning effects in technology application; and third, positive coordination and compatibility effects that proceed from the development of compatible technologies and standards (Arthur, 1994).

From the New Institutional Economics perspective, similar mechanisms come into play at institutions as well. Institutions have high start-up costs, learning effects for organizations hat emerge during institutional setup, and coordination effects in the course of the mutual adaptation of formal and informal rules (Leipold, 1996, p. 97). The path, once chosen, does not lead to a destination because every decision-making situation has alternatives; the number of alternatives is however limited by the path. Therefore, it can be fully rational to hold on to a suboptimal institution. Actors break away from the path only when efficiency losses are greater than the costs for creating a new, more efficient institution (North, 1992; Weinert, 1997, p. 83; see Ruigrok & Tulder, 1995 on globalization strategies of corporations).

In transformation research, this microeconomic reasoning has been rarely employed for a theoretical foundation of path dependency (exceptions: Murrell, 1992, 1995; Poznanski, 1996). Gerhardt Lehmbruch (1994, 1995), David Stark (1997) and others who popularized this concept share neither the rationality postulate of the New Institutional Economics nor its idea that the legacy of the past is the sole restricting power. Rather, they see the concept as an institutional resource for actors to combine and implement in different ways (see also Nielsen et al., 1995). Path dependency is therefore also characteristic for instances of institutional transformation, because in these situations actors again exploit the available institutional resources (Stark & Bruszt, 1998, p. 83). In addition, Lehmbruch underscores transmitted interpretations of situations (1995, p. 90).

This distancing from New Institutional Economics is in my opinion justified, but not for the reason proposed by Helmut Leipold. For him, an understanding of path dependency informed by technology evolution makes little sense, because in contrast to technologies, institutions are characterized by stagnating or even decreasing profits (Leipold, 1996, p. 100). For Paul Pierson, the opposite is true. He advances a number of reasons for why increasing returns to scale are applicable for “politics” (Pierson, 1997, pp. 24-36). Considerably more problematic is the New Institutional Economics assumption of objective efficiency criteria. If efficiency cannot be determined objectively for technology, as David Noble (1984) has so convincingly argued (cf. Esser et al., 1997; Ortmann, 1995, p. 260), then it certainly cannot be done so for political institutions. Efficiency ratings are driven by interests and are context dependent.

One must remember, as even path dependency advocate Paul Pierson has stressed (1998, pp. 21-26), that not every path is strewn with self-propelling sequences of events. And some sequences of events can be identified that have unintended backlashes. While in the former setting the further path is not inexorably fixed, in the latter one the path comes to an end. Accordingly, an observable path does not automatically continue into the future.

Unsurprisingly, empirical evidence is also ambiguous for the noneconomic version of the path dependency concept. Jürgen Beyer and Jan Wilgohls analyzed David Stark’s thesis of path dependency for postsocialist countries. They drew the conclusion that the first free elections had a decisive impact on the future privatization policy, but that contrary to the path dependency thesis, subsequent changes in political power relations influenced the further course of privatization. In addition, their study concluded that different privatization strategies were pursued in countries that underwent similar transformations (Estonia and Lithuania), and that other countries whose transformations were unalike chose similar privatization strategies (East Germany, Estonia; Beyer & Wilgohls, 1998).

This criticism indicates a central deficiency in the path dependency concept for societal institutions; namely, the problem of its operationalization. There are manifold ideas about what the relevant time frame and key events are that determine a given path. In transformation research, some authors highlight the significance of the presocialist history for current and future developments in Eastern Europe (Janos, 1994), while others see current developments predominately influenced by the recent socialist past (Crawford & Lijphart, 1997; Jowitt, 1992).

For Lehmbruch (1998) and Stark (1996), decisions made during the system’s collapse determined the further developmental path, although the legacy of the past influenced these decisions (see also Wollmann, 1996; Nielsen et al., 1995). Within the “U.S. job miracle” debate, however, Thomas Ertman finds 50 years to be too short a time span to define the further developmental path (specifically, his argument refers to the West German system of industrial relations in comparison with European processes of state formation; 1999).

Generally speaking, in social evolution, every initial condition has a history. For this reason, the path dependency concept is faced with the problem of infinite regression.

Yet problems of operationalization plague not only the diachronic but also the synchronic perspective. How can path-critical institutions be isolated from the multitude of institutions in modern complex societies? Key factors include the following: Party apparatus institutions, cultural heritage, and informal relationships complementary to planned economy (cf. Bohle, 1999). Moreover, external factors can also be seen as path dependency elements; for example, the magnitude of accumulated foreign debt under state socialism (Bohle, 1999, p. 18; cf. Pickel & True, 1999).

4. DISCOURSE-ANALYTICAL APPROACH

This discussion of the shortcomings of the "one best way" and path dependency concepts should not be misconstrued as a denial of the driving power of competition and institutional legacy. It should however be clear that these concepts alone can only partly explain the processes of institutional transfer. Several articles have been published in the meantime that deal explicitly with the transnational diffusion of political concepts and institutions. They provide important insights into the structural prerequisites for transfer. Accordingly, political measures diffuse easier than political institutions, and the speed of transfer is accelerated by the existence of international networks and epistemic communities. These empirical works also raise the problem of proving transfer, because not just transfers alone but also endogenous processes can result in similar-looking political measures or institutions (see overview by Stone, 1999).

Power relations are rarely treated in these works, unless it's a matter of a diffusion within hierarchically structured political organs (cf. Kern, 2000). Studies on diffusion processes in the environmental field, for instance, are marked by a basically positive attitude toward innovations, thanks primarily to the so-called "California effect" (i.e. the diffusion of higher environmental standards starting in California). The "progressive" nature of the environmental policy innovations examined seems to have obviated the need for a critical analysis of the motives and implementation strategies of their protagonists (cf. Kern, 2000; Biermann & Simonis, 1998). Because the focus was on environmental measures as objects of transfer, the diffusion of defensive tactics against environmental regulation among industry lobbyists did not catch the researchers' attention. Conversely, studies on the diffusion of concepts in the social policy field, which have experienced cuts in many countries over the last decades, highlight far more frequently the power aspects of implementation strategies for these innovations (e.g. Peck, 1999; Plehwe & Walpen, 1999). However, little heed is paid in these works to structural factors; in particular, they neglect the question of compatibility between innovations driven by power politics and the existent institutional setup. Neoinstitutional works highlight this latter aspect (Kitschelt et al., 1999; Döhler, 1991).

For a theoretical definition of both structural and actor-oriented instances of institutional transfer, I find the discourse theory developed by Ernesto Laclau and Chantal Mouffe (1985) most helpful (Scherrer, 1995). Their understanding of discourse is not limited – as most generally are – to spoken or written text, but is distinguished by an epistemological position. The substance of meaning is not determined by the essence of an object or practice, but rather by discursive articulation: "outside of any discursive context objects *do not have* being; they only have *existence*." (Laclau & Mouffe, 1987, p. 85) Such a position theoretically underpins the suggestion by David Strang and others that mimetic models do not flow, but interpretations of these boundaries do ("Practices do not flow: Theorized models and careful framings do" Strang & Soule, 1998; cf. Lillrank, 1995).

Accordingly, Laclau and Mouffe reject the idea that societal reality could be reduced to an inevitable part of an immanent law. Nevertheless, they do not rule out the existence of structures. If these were absent, then no coherent discourse would be possible because only indeterminacy would prevail (Laclau & Mouffe, 1985, p. 112). Yet structures never achieve a completeness wherein all elements are defined, but rather are vulnerable to constant interruptions and shifts. Subjects, like structures, never attain a closed identity because this comes about only in relation to other identities. What results is the reciprocal subversion of subject and structure. The subject is the product of a shift in a structure, that is the impossibility of a structure to constitute itself fully. The structure results conversely from the impossibility of a subject to continually regenerate everything that is discursive (i.e. all verbalizations and actions, all non-verbalizations and non-actions) (ibid., p. 107).

The discourse-analytical assumption of mutual subversion of structure and subject offers a plausible approach to the analysis of institutional transfer. On the one hand, it gives access to how theorists of path dependency, such as David Stark, grasp the significance of institutions for individual and collective action. It also permits an understanding of what protagonists of the "one best way" thesis stress are inevitable instances of competition. At the same time, this discourse-analytical assumption allows an actor-oriented approach. Constant structural shifts beget constant subjects; the latter are compelled through acts of identification to accept new identities and hence to also "meaningfully" join the structures of their actions (Laclau, 1990, pp. 60-67).

These subjects can recreate meanings in the imaginary realm (i.e. a realm illegible by structures) and give structures a "new sense" too, but they cannot as individuals or as subordinate collective actors change these structures voluntarily. As the enforcement of structures is decentralized and structures are not linked with each other "essentially", they also cannot be modified from a privileged position. Their existential conditions would first have to be undermined.

The absence of a center does not rule out the existence of centers, of hierarchies among the structures. Centers of societal practices can namely exist only as long as a structure is not completely closed. In the case of closure, each element of the structure would possess only a relational identity with all other elements (Laclau, 1990, p. 40). Specifically, this means that some practices or bundles of practices (institutions such as the wage or commodity relations) can structurally affect other practices.The extent of this influence rests first on the type of relation they have with the other practices and second on how far they themselves are enshrined in society. Generally, the societal availability of practices is contingent on several factors, including,

(1) how expansive they are and how long they have endured,

(2) how self-evident they have become,

(3) how negative the probable consequences of their change are estimated to be,

(4) which sanctions will be imposed if attempts at change are made,

(5) whether actors are ready to defend these practices if the previous mechanisms for maintaining them fall short,

(6) what resources they can mobilize in comparison with actors urging change; and how they use these resources.

As applied to the question of institutional transfer, these considerations entail searching for (a) – temporarily – fixed institutions including their structural elements that either enable or restrict such a transfer, and (b) – to a limited extent – open situations where actors struggle for renewed closures and in so doing become involved in interpretational conflicts. First, with respect to structures, one must ask which institutions create a competitive situation, recognized as such, that brings about a “best practice” by “natural selection”. Second, one must analyze which institutions generate institutional legacies, which in turn are also discursively recognized. In both cases, one would need to check how much the competition or the capacity to persist is also discursively grasped and to what extent an attempt is made to modify the institutions that cause these structural effects.

Deliberations on the behavior of actors in “open situations” – elaborated to a high level of abstraction in Laclau and Mouffe – may be expanded politologically with the Gramscian power theory. On the one hand, this draws attention to nongovernmental collective actors particularly in transnational relations, in the so-called “civil society” (Cox, 1987). On the other, it interprets hegemony as a relational equation between collective societal actors, whose reproduction is ensured neither by the “dull compulsion of production relations” nor by coercion, but requires other, noncoercive strategies (Scherrer, 1999, pp. 16-33). From this perspective, coalitions must be formed, in addition to active or at least passive consensus, in order to enforce institutional transfer.

The discursive strategies of institutional transfer do not however take place in a structure- and power-free realm. One must take into account, first, the power relations among the discourse participants and, second, the aforementioned structural conditions of concrete institutional transfer.

4.1. Power Constellations

Although discourse on foreign institutions can spring from an “open situation” as regards a domestic institution (e.g. because it apparently does not fulfill the defined objective), discourse participants may still be attached to the previous political structures of asymmetrical resources and participatory options. In other words, former power positions influence the options for the discursive power of interpretation in relation to a foreign model.

If my premise is correct that the transfer process starts with interest groups or political “entrepreneurs”, then their powers in the political process should be the most important factor for a successful model transfer. Research on modernization and democratization of nations (Merkel, 1997, pp. 11-15) as well as on the postcommunist transformation processes in Eastern Europe (Offe, 1997, p. 216) supports this thesis by emphasizing the role of elites. Hart concludes his international comparison of institutional adaptation to world market pressures with the observation that “movement occurred in state-societal arrangements within the bounds established by the underlying distribution of power among major societal groupings.” (Hart, 1992, p. 289) But because elites will be neither immediately nor as a group convinced of the necessity for imitation, interest formation processes must also be taken into consideration. In the process of reaching understanding amid divergent interests, actors such as policy experts, who otherwise enjoy only limited powers, can play a larger role. This role will undoubtedly grow as preliminary decision analyses are increasingly being outsourced to independent consultants, not just in the private sector (Micklethwait & Woolridge, 1996) but in policy formulation as well (for privatization, see Strange, 1996, pp. 135-146; for pension reform, see Blomert, 2001). Moreover, it stands to reason that, if there is a discrepancy between promised and actual productivity of an institution, weaker actors will assume more power. Logically enough, the media will play a key role in disseminating proposals for institutional transfer, with their actors very likely pursuing their own interests in the process.

The transfer of one country’s practices to another is also influenced by the balance of power between them. The weaker country is usually more willing to learn from the stronger one than vice versa. The stronger country’s apparent success is not the only thing that makes it more attractive; its key actors can employ more resources and provide more incentives for others to adopt its institutions. These resources might include its power within international organizations, which might be based on geostrategic motives (e.g. the United States vs. postwar Germany) or on the fear that an opposition group in another country could attain a strategic advantage (for an extreme case – reunification – see Lehmbruch, 1994, p. 29).

Yet power alone is not enough. A highhanded use of power can breed resentment and resistance. Hegemony in the Gramscian sense of furthering one's own interests by integrating those of other groups would be more conducive to model transfer.

4.2. Competition as Structure and Discourse Object

A proposal for institutional transfer is more persuasive if it is portrayed as a necessary measure for surviving a threatening competitive situation. This leads us back to the "one best way" argument. In contrast to this thesis, however, success of transfer seems to depend less on whether competition really exists and more on how much a crisis is seen as the outcome of a competitive situation. If competition is not recognized as such, then it cannot be held up as a basis for institutional change. Naturally, an actual but unrecognized competition mechanism can still have an impact; for example, it can lead to military defeat, to bankruptcy, or to high unemployment. But whether the defeat is retrospectively associated with the competition mechanism is an open question. Even if a competitive situation is recognized as such, imitating "best practice" is not the sole option for action. Recognition can lead to efforts to "outrun" the competition or, if catching up seems futile, to discontinue further efforts. Interpreting a crisis as the outcome of a competitive situation will seem more plausible if supported by everyday experience: At one extreme, by war; or in times of peaceful economic competition, by experiences in the consumer world and at the workplace.

The U.S. manufacturing industry unions, for instance, long ignored European and Japanese competition, dismissing it as a "foreign competition hoax" during the 1959 steel strike, which gave foreign steel producers a breakthrough on the U.S. market. Later, when steel industrialists concluded that it was not possible to catch up with the new competition and made cuts in the investment budget accordingly, unions successfully advocated protectionist policies, using them to obtain wage increases that were out of proportion to productivity gains (Scherrer, 1992, pp. 171-182).

In this case, there was an "objective" competitive relationship. The institutions of private ownership, trade, the GATT, and price-sensitive purchasing decisions pitted steel producers against each other in international competition. Yet this competition was not immediately recognized by those involved; once it was generally acknowledged in discourse, one of the institutions held responsible for the situation, the GATT, could, through political power, be circumvented or made ineffective by "voluntary" export restrictions. Although competition could not be fully offset in this manner (i.e. its effects were manifest in the investment behavior of U.S. firms and, years later, in a major steel crisis), its impact was limited.

4.3. Institutional Compatibility

Foreign practices are more likely to be adopted if they are compatible with existent values and institutional arrangements. This is the most common argument in the literature for the dissemination of ideas and policies and is most akin to the path dependency argument. It is justified primarily by "interaction requirements" (Scharpf, 1978, p. 363). Not one type of institution alone creates a system, "but the simultaneous existence and the pattern of interaction of a series of institutions." (Niosi et al., 1993, p. 218) The transfer of a model representing only parts of an entire institutional configuration is therefore faced with the problem of institutional coherence. As industrial geographers Storper and Salais so forcefully argued,

> "[…] the strength of any successful real world of production is precisely the way in which it is chiseled out of conventions which function together coherently and are made possible by conventions of identity and participation: These elements cannot be mixed and matched á la carte." (Storper & Salais, 1997, p. 172)

Furthermore, the adoption of foreign institutions is structurally limited by procedural knowledge. Changing procedural knowledge is difficult and can only be achieved with the passage of time, because such knowledge is implicit. People learn rules without conscious knowledge of them, and these rules are stored as procedural memory. Procedural knowledge is also rooted in identities that are given by the existent categories defined by the societal division of labor (Kogut, 1997, p. 358; for transformation research insights on this topic, see Wiesenthal, 1997).

Finally, David Strang and John W. Meyer point out that culturally biased objectives, where dissimilar, can hinder institutional transfer (Strang & Meyer, 1993, pp. 490-492).

The more familiar the model institutions are, the less affected the power relations between the societal actors will be and hence the lower the resistance. If many of the existing institutions need to be changed, then the inadequately fulfilled interaction requirements with other institutions during the implementation process will increase the risk that the initial innovations will fall short of the anticipated efficiency gains or other advantages. This disappointment can cast doubt on the further implementation (see above).

Institutional restraints on adopting foreign practices will be illustrated by an example from Germany. Despite its great interest in Henry Ford's production techniques and labor relations, prewar Germany was not yet ready for Fordism. The introduction of American production methods was barred by the German industry cartel, which enabled small producers to stay in business (Berghahn, 1986, p. 22). The adoption of Taylorist concepts, many of which were indigenous to Germany, was nevertheless impeded by a societal order with institutionalized skill identities (the *Meister*, the *Facharbeiter*) upheld by political actors (Kogut, 1997, p. 360).

In 1996, the boards of directors of several German firms supported decentralized wage bargaining in line with the American model. Apart from the strength of the unions, many large industrial employers were ambivalent about this demand. As Kathleen Thelen has pointed out, they feared that, if works councils were actually to take on more of the bargaining responsibilities traditionally reserved for unions, this would in fact very likely undermine the foundations on which management's constructive relations with their works councils were premised. This relationship rests on the works councils' inability to negotiate. Indeed, decentralized bargaining could even open possibilities for plant labor representatives to use works councils' rather significant legal rights to extract concessions from management over wages (Thelen, 1997).

Institutional or mentality restraints, however, can be overcome with the passage of time. Either the institutional setting adapts to the new practices, or these new practices are adapted to the old institutions. For Berghahn, who has studied the postwar transformation of West Germany's industrial structure, the resistance to "Americanization" subsided when a new generation assumed leadership positions (Berghahn, 1986, p. 11). The younger generation embraced American methods more readily, first and foremost because they apparently worked (see above).

Even if foreign practices are adopted, the copy is not identical with the original. For example, when Taylorism was finally introduced in Germany, it did not lead to a deskilling or to the imposition of crude incentives to the extent seen elsewhere, because the belief in sustaining the role of the skilled laborer in the production process was retained (Kogut, 1997, p. 362).

Besides the problem of adopting all supporting institutions of a foreign practice simultaneously, a principle obstacle is that a prototype is not a fixed template. There usually is ample space for disagreement about the central features of the model to be copied. For instance, many firms claim to have installed Japanese production methods. However, most of them have only adopted a fraction of what makes the Toyota system "best practice", and they usually have adapted this part to fit the surrounding practices. In these cases, transfer may lead to institutional innovations (Jürgens, 1993).

5. CONCLUSION: BEYOND PATH DEPENDENCY AND "ONE BEST WAY"

The upshot of the discussion is that neither the thesis of competition-induced "one best way" nor path dependency can adequately explain whether transnational institutional transfer is possible or not. The thesis by which, under penalty of ruin, the most efficient practice has to be adopted stands both empirically and theoretically on thin ice. Empirically, no clear trend toward convergence is discernible, price alone is not the decisive factor in competition (and identical prices could conceal very different combinations of input factors or institutional settings), and many economic activities are not subject to direct competition. According to the "theory of comparative institutional advantages", it is precisely competitive conditions that form the groundwork for the specialization of economic policy institutions.

There is likewise no clear-cut empirical evidence for the path dependency thesis, which sees the legacy of existing institutions to be a restraining factor in the possibilities for institutional transfer. In addition, the thesis can be difficult to operationalize. There are myriad contrasting ideas about the relevant time span and the major events that shape the respective path.

In summary, the spectrum between the poles of "one best way" and path dependency leaves room for a multiplicity of institutional combinations. To determine their concrete shape, I have chosen a discourse-analytical approach that, without having to deny the power of competition and institutional legacy, increases awareness of the political conflicts surrounding institutional transfer. This approach cannot provide any simple explanations, however, as it deals with the "radical contingency" of all relations between societal interests, identities, and positions.

A good starting point for a prognosis, based on the deliberations above, would be the relative power relations between advocates and opponents of institutional transfer. These relations, defined by the availability of economic, political, and media resources, represent just one approach, however. The proposal to copy a foreign model can achieve a much greater response if it is packaged as a solution to a problem deemed pressing by the majority of people. The work of persuasion can be facilitated by the following factors: Prevailing consciousness of strong competitive pressure; extensive compatibility of the envisaged policies and institutions with existent values and institutional structures; a powerful and interested model country or international organizations; and a model that lives up to the expectations of its proponents.

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NOTES

[1] This chapter emerged in the context of my work in the DFG-funded research project "From the Chandlerian Business Model to Wintelism" in the Work Regulation Division of the Social Science Research Center, Berlin. For their helpful suggestions, I would like to thank Reinhard Blomert, Bernhard Ebbinghaus, Ulrich Jürgens, Kristine Kern, Thomas Sablowski and the participants in Michael Schumann's research colloquium at the Sociological Seminar of the Georg-August-Universität, Göttingen, especially my commentator, Ulrich Voskamp.

[2] Among the Public Choice authors, Mancur Olson has dealt the most with competition between individual polities. For him, "distribution coalitions" prevent political orientation on the best practice, which leads to the ruin of the nation in question. In his eyes, "learning" does not take place (Olson, 1982).

[3] This argumentation could be refuted by the fact that it is based on a static version of "best practice". From a dynamic viewpoint, "best practice" will continually repeat itself – innovations will be taken up by everyone else in turn. This viewpoint implies however that the institutional transformation does not strictly orientate itself on the best model but can be influenced by other factors. But then there would be far less pressure to adopt the "best practice" and more room for a variety of practices.

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Chapter 3

STEFAN BECK

AFTER THE MIRACLE

The Exhaustion of the German Model?

1. INTRODUCTION: FROM GROWTH TO COMPETITIVENESS

In the post-World War II era, the German economy was long admired for its impressive performance. High growth rates, full employment, and low rates of inflation nourished the talk of the so-called *Wirtschaftswunder* and even dreams of never-ending prosperity (Lutz, 1984). Although these dreams ended suddenly in the 1970s of the last century with the "oil shock" and the following period of "stagflation" (stagnation in conjunction with inflation), the German economy still coped comparatively well with this "crisis" (Esser et al., 1983).

In the 1980s things changed. With regard to growth and employment, a persistent gap opened up between Germany and other OECD economies, which was only temporarily obscured by a countercyclical (i.e. against the international business cycle) upswing resulting from eastern German backlog demand after the fall of the Berlin wall (Herr, 1994; Organization for Economic Co-operation and Development [OECD], 2002). At this time, both home and abroad, confidence in the strength of the German Model began fading away. Once belief in the steering capacity of the state had been lost, even among Social Democrats, the public debate was characterized by a strong – and sometimes irrational – discourse about the supposed economic and societal dangers of (rising) public expenditure (Herr, 1994). While trade unions and parts of the left diagnosed a decoupling of economic growth and employment and favored a redistribution of work as well as a relaxation of the bonds of the welfare state to (regular) employment, employers, conservatives and liberals saw a national or European ("eurosclerosis") weakness as a result of institutional inflexibility and unfavorable supply conditions (cf. Ganßmann & Haas, 1999). The demands of the latter included lower costs for enterprises in general and lower labor costs achieved by more flexibility and a reduction of social contributions in particular (cf. Schmid & Tiemann, 1990; Eicker-Wolf, 2003).

A climax and, looking back, maybe one of the most crucial events in this confrontation was the introduction of reduced weekly working hours in 1984 after a fierce labor dispute in the metalworking industry. Against heavy resistance from

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employers' associations, the Metalworkers' Union (IG Metall) reached a breakthrough concerning the ”tabooed” reduction of working time, which implied a reduction to 38.5 hours weekly and was to be a prelude to further reductions in the following years. However, with the introduction of company-level agreements, which meant decentralization of collective bargaining and of industrial relations in general, unions not only paid a high price but also opened the door to subsequent decentralization, flexibilization, and organizational problems of the employers' association – the unions' counterpart in the collective bargaining system. From an institutional point of view, this event can be seen as one of the first and important cracks in the foundation of the German Model (Beyer, 2003, p. 19; Dittrich, 1990; Schroeder, 2000).

In the 1990s, and after reunification, the debate about the strength (or rather the weakness) of the German economy changed once more – gradually but in an important way. After a phase of more or less vague awareness of the growing international competition by Japanese products, first the ”discovery” of the Japanese model of production (”lean production”, cf. the best seller by Womack et al., 1990) and later the idea of ”globalization” or global competition shifted the focus of the so-called *Standortdebatte* (a very emotional debate about locational [dis-] advantages) definitively from ”growth” to ”competition” and – maybe more importantly – from a macroeconomic to a microeconomic perspective (cf. Yamamura, 2003).

While the arguments of employers and many economists varied rather gradually, the change in the position of trade unions was striking. In accordance with the decentralization process in industrial relations, unions too more or less adopted the microeconomic view that improving competitiveness would be the crucial task for the future of the German economy. Though not as obvious as in the United States, where unions' – involuntary – behavior often was labeled as ”concession bargaining”, German unions propagated the role of labor as ”co-management” and actively helped to reduce costs or raise productivity (cf. Rehder, 2003).[1] The predominant aim was no longer to improve macroeconomic development and the situation of labor in general; instead, rather modestly, it was to keep production and *existing* jobs ”at home”. As the term *Standortkorporatismus* (corporatist politics in favor of one's own location) – as critics called this ”arrangement” between capital, labor, and the state – indicates, this does not mean a break with the corporatist tradition of the German Model. On the one hand, German corporatism was always based on – or at least tolerated – a certain degree of exclusion or separation between ”insiders” and ”outsiders”. Therefore, Joachim Hirsch (1995, p. 175) talked about a ”socially highly selective neo-corporatism”, and Martin Rhodes (2000) used the term ”competitive corporatism”. On the other hand, looking at the high prominence of export surpluses, international competitiveness was always an important issue for the German economy and its success was not least based on cooperative and comparatively ”peaceful” industrial relations (Hollingsworth, 1997). Up until today, Germany is one of the countries with the lowest amount of working hours lost due to labor disputes (Müller-Jentsch, 1986; 2000).

Besides these moments of continuity, however, there is also a fundamental change visible. The perspective of international competition, previously related more to macroeconomic success, is now used microeconomically to scrutinize nearly every institution, organization, and even individuals. The labor market, the welfare state, taxation, or public policy – there is almost no domain of society left for which the exercise of ”benchmarking” did not diagnose some comparative disadvantage.

In order to assess the stability of the German Model and its potential to return to higher growth, these alterations of existing institutions and the discourses about their capabilities are important. The identification of challenges, problems, and possible solutions, as well as the operation of institutions, is shaped by perceptions, theoretical assumptions, and the strategies of actors.

In this chapter, the problem of slow growth and high unemployment is discussed from different perspectives. At first, the most frequent arguments of the economic mainstream, that is inspired by neo-classical economics, are presented. Such interpretations, for example, debated internationally by the Organization for Economic Co-operation and Development (OECD) and in Germany by the *Sachverständigenrat* (SVR; German Council of Economic Experts) and economists of the Kiel Institute for World Economics, are primarily microeconomic and especially highlight deficient labor market or wage flexibility, inadequate incentives, and high costs (cf. OECD, 2002; Sachverständigenrat [SVR], 2002; 2003; Siebert, 2003).

In the subsequent sections, this argumentation is reviewed in several ways. On the one hand, supposed *comparative disadvantages*, in particular concerning labor market rigidities or wage differentials, are questioned theoretically and – comparing Germany and the United States – empirically. On the other hand, when rising competition in the course of globalization is seen as the central challenge for which the German economy is supposed to be poorly equipped, than this weakness should be reflected in international *competitive disadvantages*; for example, concerning exports, unit labor costs, or the innovation system. However, the microeconomic view turns out to be unsatisfactory. It does not, as regards the peculiarities of the German Model, provide a convincing explanation of why former strength has turned into current weakness (cf. Logeay, 2003). Therefore, it is helpful to look for other explanations. Based on a (Post-) Keynesian interpretation of the concept of *mercantilism*, it is possible to build a macroeconomic framework that provides more insights into three phenomena central to understanding the German economy:

(1) The link between the national and the international economy, in which the latter always played a prominent role for Germany;

(2) the tension between (microeconomic) competitiveness and (macroeconomic) growth and employment;

(3) the historic reversal from growth to stagnation.

In the last section, recent politics and programs of the Red–Green government and their impact on the German Model are discussed. The Red–Green government has propelled significant and probably lasting alterations to the German Model and its operation (see Beck and Scherrer's chapter in this book). However, the success of these reforms is questionable. At least there are some clues that the real problems are rooted less in an exhaustion of the German Model and more in a problematic national and European macroeconomic framing (Truger & Hein, 2002).

2. THE MICROECONOMIC VIEW OF THE GERMAN DISEASE

After the technocratic version of Keynesianism[2] – as used in Germany by Social Democratic governments and in the United States by the Nixon administration – had lost most of its appeal, a "new" economic view became more and more paradigmatic and (then) hegemonic (for a detailed discussion, see Campbell & Pedersen, 2001; for Germany, see Eicker-Wolf, 2003). It consisted of different approaches (e.g. supply-side economics, monetarism, general equilibrium theories), all sharing the methodological micro-foundation of neo-classical economics. Central to these concepts is the conviction that (apart from a few exceptions) markets are self-regulating and macroeconomic steering policies useless, if not harmful. The existence of (temporary) imbalances, for example, unemployment, therefore would be the result of a hindrance of market forces caused by external regulations, wrong incentives, or dysfunctional policies (cf. Heise, 2001).

At first sight, these concepts seem to be rather theoretical, but their influence on the analysis of real economies, reform proposals, and economic policies is evident. If we were to compare different national models of capitalism from this point of view, German or Rhenish capitalism must look like a pathological case. Given the corporatist tradition, labor market regulations, the welfare state, and all kinds of entanglement, Germany's weakness must be self-evident.

Because of its high reputation, the work of the OECD, especially its *Economic Survey of Germany* (2002), is an excellent reference for the following discussion.[3] In its assessment of the German economy, the OECD assumes low employment caused by "structural incrustations" as the main reason for low growth since the 1990s. Additionally, this internal weakness made the economy less resistant to "external shocks" such as unification and the concomitant economic stress. Not entirely clear is the relevance attributed to private consumption. At first glance, it seems that low consumer demand – in comparison with other OECD countries – is attached an independent *macroeconomic* role in terms of explaining low growth (OECD, 2002, pp. 19 and 22). However, since this view is not readily compatible with neo-classical reasoning, the OECD survey puts forward microeconomic arguments for Germany's low domestic demand: From low employment, a merely small increase in disposable personal income, and a decline in consumer confidence caused by deteriorated labor market prospects (ibid., p. 19). So the central problem is seen in a disturbance of the labor market as a result of several institutional and political interferences:

(1) In the first half of the 1990s, rising taxes and social contributions to finance transfers to eastern Germany curtailed the disposable income of workers and lowered employers' demand for labor.

(2) Deficient incentives caused by generous benefits (unemployment insurance system, welfare) in conjunction with high taxes (marginal tax rate) discourage low-wage earners from taking up work.

(3) Cost-increasing labor market regulations, especially dismissal protection, also lower the demand for labor or motivate employers to use more non-regular forms of employment, for example, short-time work or minor jobs (*geringfügige Beschäftigung*).

(4) The institutional framework of employment protection procedures, collective wage contracts, and codetermination impedes wage and labor market flexibility, especially at the company level.

Labor market imbalances are thus at the core of a system of cumulative or mutually reinforcing problems. On the one side, low domestic demand increased the dependency on foreign demand and exports; on the other side, rising labor costs also caused a decrease in international competitiveness. Finally, and not directly related to growth but rather to matters of allocative and dynamic efficiency, there are some sectoral and institutional deficiencies regarding the regulation of (product and financial) markets, the federal system, public administration, and the educational system.[4]

Of course, the OECD survey mentions the costs of German unification. The transfer of the western German welfare state and extensive financial transfers raised social expenditures overall and the social security contributions of employers thereby increasing labor costs per hour. Furthermore, the survey takes a critical look at the extent and allocative effects of subsidies, state aid, and tax relief. Besides the generally acknowledged risks of *Mitnahmeeffekte* (free riders) and administrative inefficiencies, it criticizes especially negative allocative effects on investments, for example, crowding-out effects, and the inherent bias toward capital-intensive investments (OECD, 2002, p. 22; see also Gerling, 2002). However, the criticisms of the OECD are centered on the high amount of expenditures without looking at the institutional and political causes of eastern Germany's weakness (cf. Altvater, 2001; Priewe et al., 2002).

According to this diagnosis, the recommendations of the survey put special emphasis on structural reforms of the labor market (OECD, 2002, pp. 83–122):

(1) Increasing the flexibility of labor costs, wage formation, and of working time (e.g. more differentiated and company-level bargaining

agreements, temporary work, contingent pay, restrictions of codetermination, attenuation of working time regulations, reduced incentives for early retirement).

(2) Relaxation of the dismissal protection regulations.

(3) Reducing labor market distortions resulting from transfer payments (e.g. lowering the *reservation wage* [expected minimum wage for taking up a job] by reducing transfers and introducing stricter eligibility regulations).

(4) Ameliorating active labor market policies (focusing, enhancing efficiency, more competition).

(5) Deregulation and privatization of regulated sectors and markets, including the public banking sector.

(6) Further lowering of taxes and social contributions, and continued consolidation.

In sum, the OECD survey suggests doing away with many core features of the German Model of a negotiated economy. However, their arguments do not go unchallenged. On the one hand, macro economists question the theoretical foundation of this microeconomic diagnosis. On the other hand, institutional economists doubt whether the OECD policy prescriptions will lead to growth.

3. THEORETICAL FLAWS IN THE MAINSTREAM DIAGNOSIS

If repetitiveness were the crucial criterion for the quality of an argument, there could be no doubt as to the causes of slow growth and high unemployment in Germany. Apart from a few exceptions (heterodox economists, left-wing politicians, unionists), it seems to be an unquestionable fact that structural incrustations and a lack of consistent reforms especially regarding the labor market and the welfare state hamper necessary adjustments to globalization and therefore a recovery of the German economy. One of the most widespread arguments in this context is the assertion that German wages or labor costs are characterized by downward rigidity and – as also often assumed – are therefore on average too high. This lack of downward flexibility is held responsible for deficient demand for (especially low-qualified, low-wage) labor and an enduring exclusion of less productive labor from employment. Hence, there is demand for a greater spreading of wages and therewith the development of a low-wage segment in the labor market. The link between the labor market and the welfare state in this framework is primarily seen in the fact that reservation wages are too high because of too generous unemployment benefits: To serve as an incentive to take up work, the minimum wage must be at least as high as the ”alternative” welfare or unemployment benefit *plus* a compensation for the additional effort of work or the loss of leisure time. Of course, the question is not whether minimum wages are high enough but whether welfare payments are low enough (cf. Grell et al., 2002; Herr, 2002a).

To be sure, the point is not the *existence* of flexibility-restricting labor market regulations; of course they do exist. Rather, the question is whether these regulations can be seen as the main reason for macroeconomic stagnation, and – more importantly – are reforms necessary and would they be sufficient? Besides the comprehensible endeavors of employers – particularly of small and medium-sized enterprises – to improve their competitive position, the focus on labor markets is usually based on two perceptions: First, the theoretical key position of the labor market and the explanations of unemployment in neo-classical (or Walrasian) economic theories and also in New (Keynesian) Macroeconomics (for a critical overview, see Schettkat, 1996; Hein, Heise, & Truger, 2003), which more or less accedes to the neo-classical micro-foundation (Herr, 2001). A second line of argumentation is based on international comparisons with (more) liberal market economies and thereby a selective attribution of macroeconomic success to less regulated labor markets. The most preferred example in this context has been the United States, especially during the New Economy.

Both argumentations have been questioned on several grounds. I will start here with a discussion of the theoretical models and the pivotal position given to the labor market. In the subsequent sections, I will discuss statements about the deficient flexibility and adaptability of the German – compared to the U.S. – labor market.

In neo-classical economics, the labor market is no different from other markets. On the basis of calculations to maximize profits (companies) or utility (households), economic actors adjust the quantities of labor they demand or the supply to a given price (wage). Vice versa, the price mechanism makes sure an equalization of supply and demand (i.e. at equilibrium involuntary unemployment cannot exist). In this model, external shocks or changes (e.g. new technologies, competition, migration, demography) would induce an adjustment process of prices and quantities until a new equilibrium is reached. The crucial point is that this adjustment process only works when there are no regulations or restrictions to hinder it; for example, minimum wages or collective wage contracts. The functional logic is therefore very simple: In the case of existing unemployment, wages have to fall until (voluntarily) reduced supply meets increased demand. Any existing obstacles to this adjustment should be removed.

Yet as simple as this model looks, there are many assumptions and restrictions necessary for its operation – above all regarding the macroeconomic level. Making assumptions and simplifications can be an useful procedure to build comprehensible theoretic models for analyzing complex issues. It becomes problematic when those assumptions that are crucial for the operation of the model conflict with or even contradict reality (cf. Herr, 2002a; Priewe, 2003):

First, the neo-classical model of the labor market allows only very limited and conditional statements about the *operation* of real labor markets, and even the model itself is not unambiguous. In view of the existence of more than one capital good, different technologies and branches, and alternative – but nevertheless methodologically consistent – behavior, the generally applied curves of labor supply and demand represent little more than special cases: Usually the labor supply curve is based on the general assumption that the supply of labor increases when wages rise and decreases when wages fall. But that must not always be the case. For example, if individuals put a higher value on additional leisure time than on additional income (perhaps because they already earn enough), they could reduce their labor supply when wages rise. On the other hand, when wages – for example, for low-qualified jobs – are already low, a further fall could induce a higher labor supply, because affected workers may have fixed expenses or want to maintain their standard of living (or, as is often the case in developing countries, wages fall below the minimum subsistence level and they have no other choice). In these cases, there is either no unique equilibrium or the realized wage depends on labor market regulations (e.g. labor standards) and on the power of labor market parties (e.g. unions). Additionally, firms usually apply specific technologies. Therefore, in the short run, the quantities of capital and labor used in the production process are only to a certain extent mutually exchangeable or combinable. Consequently, the real effects of changing wages are not clear. There is no guarantee whatsoever that lower wages or a growing wage spread would lead to significantly higher employment or less unemployment (Herr, 2002a).

Second, the *relevance* ascribed to the labor market and to labor market regulations for *macroeconomic* development and growth can only be comprehended by making a few heroic abstractions from reality and by neglecting macroeconomic factors. Even though neo-classical theories make macroeconomic statements, they do not contain a theoretically relevant macroeconomic component. Macroeconomic processes are a mere aggregation of microeconomic decisions and actions, without having an independent relevance. A typical example of this problem is the misleading analogy between the (aggregate) labor market and individual contracting. While a choice between income (wage) and employment opportunities may be comprehensible for individuals, on an aggregate level the same logic is flawed. On an aggregate level, wages have an influence on the general price level, the generated income, and resulting effective demand. A singular (equivalent) barter is a completed action, but macroeconomic quantities are moments of circular processes. Unfortunately, the assumption of an analogy is widespread (even among economists – e.g. SVR, 2002; 2003 – and unions) and responsible for the pertinacious belief that a dispensation with real wage increases (below productivity increases) would be an adequate way to increase employment (cf. Flassbeck, 2000; Flassbeck & Spiecker, 2000).

Third, neo-classical or Walrasian approaches assume a *barter economy* and only work when *historical* time is replaced by *logical* time and real *uncertainty* by *calculable risks*. In this way, the future is ”reduced” to the present and contingency is excluded. In this framework, money is an external quantity and has no relevance for ”real” economic processes. If, in contrast, existing uncertainty and historical time are accepted, then *money* becomes an important factor, too, because now economic processes go sequentially and decisions are based on uncertain expectations about the future, that is money is no longer a simple lubricant for the execution of a system of entirely known barters. Decisions to spend or to save money, about credits and investments have their own consequences for future economic developments. Consequently, *(Post-) Keynesian* economics assumes a hierarchy of markets, in which capital or asset markets take the lead and the labor market follows. Moreover, in this context, regulations that limit the (downward) flexibility of wages are seen as stability anchors and, particularly in a recession, could protect the economy from deflationary processes.

This brief discussion of some fundamental shortcomings shows that the microeconomic perspective with its emphasis on the labor market is at the least built on fragile theoretical grounds. If we were to strip it of its assumptions, not only would many statements appear impossible, because we simply do not know what happens, but the theory would have to be reformulated as well. Even if this framework were not rejected, it would be very problematic to derive concrete policy advice from it.

4. INSUFFICIENT EMPIRICAL EVIDENCE FOR GERMAN SCLEROSIS

While the theoretical underpinnings of the labor market argument have been shown to be flawed, the empirical evidence for ”incrusted” European and German labor markets does not fare better. Long before the advent of the New Economy, proponents of the Euro- and particular German sclerosis thesis have used the United States as a contrasting showcase. Beginning in the mid-1980s, the United States enjoyed impressive above-average increases in employment and growth, seeming to justify liberal and conservative endeavors to implement supply-side oriented reforms. Above all, higher average and structural (spread) wage flexibility and lower employment protection regulations were to make the American economy more dynamic and adaptable to the requirements of globalization (e.g. Giersch, 1985). By contrast, high long-term unemployment in Germany was taken as evidence of incrustation. Rising productivity, far from being a sign of international competitiveness, was first of all seen as the result of exclusion and loss of less-qualified, less-productive work. The latter interpretation, often expressed as *Entlassungsproduktivität* (productivity gains caused by dismissals and the substitution of factors, not by technological progress), has until now been a central argument (e.g. of the OECD and the German Council of Economic Experts) explaining high German unemployment and low growth despite rising productivity (e.g. Scarpetta et al., 2000, p. 22).

However, the U.S. experience does not justify the call for more (downward) wage flexibility, the establishment of a low-wage segment, and less employment protection. Until the deindustrialization of eastern Germany in the wake of unification, unemployment in the United States was on average not below German unemployment. In the United Kingdom, the European model of a liberal market economy, unemployment was significantly higher until the mid-1990s (Ganßmann

& Haas, 1999; Schettkat, 2002; Weiss, 1998). As empirical investigations have shown, the United States' employment success in the 1990s is not just the result of greater demand for low-wage, low-skilled labor. On the contrary, in relation to overall unemployment, the unemployment rate – or share – of less-skilled workers in the United States was even higher than in Germany and many other OECD countries (Schmitt & Mishel, 2000; Wagner, 2003). Comparing the U.S., German and Dutch labor markets with regard to the distribution of skills, Ronald Schettkat (2002, p. 15) from the Utrecht University comes to similar conclusions: In contradiction to the wage-compression hypothesis, the "skill difference between the employed and the unemployed is especially high in the U.S. but much narrower in the Netherlands and in Germany". Comparing the skill difference with the wage difference, he finds that "wages at the low end of the labor market are not more compressed in Europe but rather in the U.S.A." (ibid., p. 17).

Another argument of the "incrustation" thesis, significantly lower rates of long-term unemployment in the United States, is trickier. On the one hand, eligibility periods and criteria for unemployment insurance and welfare payments have significant effects on registered unemployment. On the other hand, their impact on the extent of unemployment irrespective of bureaucratic accounting procedures is a matter of dispute. Low levels of benefits and bureaucratic hassles often discourage the unemployed from registering. Forced to take any job available, the unemployed end up in insecure jobs that do not guarantee continuous employment. They may find themselves quickly out of a job again (Peck, 1999). Additionally, lower levels of welfare benefits may foster criminal activities (the U.S. prison population is five to six times higher than in Europe). Hence, the difference would not be the absence of long-term unemployment but of its "perforated" form (Ganßmann & Haas, 1999; Grell et al., 2002; Heise, 2001).

Furthermore, and to turn the model on its head, in comparison with Germany and other European countries, real wages in the United States have risen more quickly – not more slowly – and, since 1980, tracked the development of productivity more closely than in Germany, where productivity outpaced real wages by a widening margin (Flassbeck & Spiecker, 2000).

And finally, in the last 20 years the supposed institutional rigidities of the German labor market have been reduced (and not increased), the conditions for benefits have tightened, and wage dispersion has risen without relevant employment gains since the 1980s (Priewe, 2003; Wendl, 2002; Schäfer, 2003). As empirical investigations have shown, for example, the relaxation of employment protection by the Employment Protection Act (Beschäftigungsförderungsgesetz) in 1985 "had no significant employment effects, even in periods when it might be expected to have the strongest impact" (Schettkat, 2002, p. 12).

The weak evidence for the incrustation thesis suggests other reasons for growing employment in the United States. First of all, there are at least equally good reasons to ascribe United States' growth and employment performance to other – macroeconomic – factors and not primarily to labor market flexibility. In particular, and in contrast to the European Central Bank (ECB) and formerly the German Bundesbank, the U.S. Federal Reserve Board has pursued an anti-cyclical monetary policy since the 1980s that not only takes care of monetary stability (low inflation) but also pays attention to growth and employment. Additionally, expansive macroeconomic effects have resulted alternately from public expenditures (e.g. during the Reagan administration), growing consumer demand at the expense of private savings, and extensive investments supported by booming asset markets (e.g. during the New Economy) (Evans, 2001; Baker, 2000; Dräger, 2001).

During the New Economy in the United States, private consumption rose about five percent annually and its share of gross domestic product (GDP) rose to nearly 70%. By contrast, in Germany the share of GDP going to private consumption remained below 60% and annual growth rates below two percent. Thus, while the German economy is often typified as being export-driven, the U.S. New Economy boom was sometimes characterized as being consumption-led (Baker, 2000; Arbeitsgruppe Alternative Wirtschaftspolitik [AAW], 2001). The massive reduction of private savings and increasing private indebtedness were also crucial for the success of public consolidation – without having depressing effects on growth – during the Clinton administration. The German Finance Minister, Hans Eichel, has had bad luck in that he has tried to consolidate public finance in times of increasing private savings, a tight monetary policy, and reluctant investments. This Sisyphean task is even worse than it looks: As a consequence of decreasing tax revenues caused by stagnation and the tax reform Eichel bears partial responsibility for, public indebtedness has actually risen (cf. Flassbeck, 2003a).

Perhaps the most important reasons are strong population growth, continued immigration, and significantly higher employment of women. Higher labor market participation of the latter not only allowed new employment opportunities but also had positive economic effects on private consumption and labor demand (Scherrer, 2002; Ganßmann & Haas, 1999).

Last but not least, expansionary trends of the U.S. economy are alimented by *seignorage* gains and large capital inflows owing to the exclusive role of the U.S. dollar as global currency (Scherrer, 2001).[5]

In sum, theoretical considerations as well as empirical evidence suggest that it cannot be expected that a higher downward flexibility and dispersion of wages or a reduction of employment protection would result in higher growth and less unemployment. On the contrary, as a cost factor of production, labor costs are the main determinant of prices. In the context of tight monetary policy and public consolidation efforts, real wage increases below productivity increases or even a decline in wages could induce deflationary processes and would merely deepen the present recession (Herr, 2002a; Flassbeck & Spiecker, 2001; Kohnz & Erber, 2000; Priewe, 2003).

Without having a proper institutional approach apart from a general suspicion of every institutional regulation, the microeconomic view cannot assess the impact of individual institutions and overlooks complementarities and existing functional equivalents, for example, regarding employment flexibility. Therefore, the residual explanation of German unemployment being a *hysteresis* phenomenon and the product of a too-limited reach of reforms so far remains weak. For example, at the end of the 1980s and in response to the unification boom, employment in western Germany rose very quickly and substantially after an increase in demand and even helped to integrate the long-term unemployed (Schettkat, 2002, p. 4; Heise, 2001).

What remains of this microeconomic perspective is the alternative explanation of low growth being a consequence of lacking international competitiveness and hence a loss of market shares. This argument is discussed in the next section.

5. HAS GERMANY LOST ITS COMPETITIVENESS?

Whereas the previous discussion was related to a closed economy, now specific aspects of an open economy are examined. Recently, two areas of competitive disadvantages in the German economy have been identified. A ”traditional” variant, inspired by classical *trade theory*, expected rising competitive pressure from developing and newly industrialized countries, which would have a *comparative advantage* resulting from abundant cheap labor, that is lower labor costs. This argumentation was hardly related to the peculiarities of the German production model and almost exclusively emphasized high wages or labor costs in Germany. But in the course of the New Economy boom, a second focus emerged. *New* or *endogenous growth theories* helped to identify a growing gap between Germany and other leading industrial countries in the fields of high technology, innovations, and corresponding structural change. This theme was also discussed internationally by rather heterodox researchers from disciplines ranging from Economic Geography to Institutional Sociology. In the comparison of different *innovation systems,* it is also a central issue of the *varieties of capitalism* approach, where it is explicitly analyzed as an integral part of national models (e.g. Boyer, 2003; Becker & Vitols, 1997).

As Ulrich Jürgens (2003; see also Hancké, 1997) has shown for the (paradigmatic) automotive industry, the formerly virtuous circle of German high-wage, high-skills, and high-commitment *diversified quality production* mutated during the 1980s into a vicious cycle. A combination of neglected organizational modernization, misdirected development strategies, and the ability of Japanese competitors ”to produce quality and diversity at much lower costs” (Jürgens, 2003, p. 221) threw the proportions of high labor costs and high productivity off balance. The elusive fact that the high value of the U.S. dollar during the 1980s masked the loss of competitive advantages even deepened problematic trends. Thus, there indeed existed a problem of competitiveness, at least partly rooted in the institutional configuration – and yet in existing complementarities – of the German production model.

However, this diagnosis was not typical for the dominating *Standortdebatte* and at best supports single moments of the latter. In contrast to the latter’s mostly unidimensional focus on *factor costs*, the weakness Jürgens identified resulted from *system dynamics* and inherent logics (ibid., p. 224). Moreover, complaints about high labor costs and incrusted institutional structures not only arose *before* the crises of the production model became evident, but also continued *after* the phase of reorganization – or more precisely, *hybridization* – and re-establishing competitiveness in the 1990s. Last but not least, and also in contrast to the incrustation thesis, the benchmark was not a liberal market economy, but the socially highly regulated Japanese production model, and factory reorganization as well as the adoption of new principles demonstrated the adaptability of the German Model (ibid., p. 230).

The most popular criterion for demonstrating a competitive disadvantage of the German economy remains wage or unit labor costs. Despite continued usage by employers (e.g. Institut der deutschen Wirtschaft, 2001), pure *labor costs* are not appropriate for international comparisons of competitiveness, since they do not take into account important factors such as productivity, purchasing power, and product quality (Krugman, 1999; Lindlar & Scheremet, 1998). As already mentioned, comparatively high wages have been a functional feature of the German production model and cannot be assessed adequately without paying attention to productivity and other elements of the model, such as qualifications or product strategy. Comparisons of *unit labor costs* are problematic because of methodical deficiencies and the influence of selected data (e.g. time series) on the results (Müller & Kornmeier, 2000; Deutscher Bundestag, 2002). Generally, comparing unit labor costs is only meaningful related to their dynamics.

A first glance at the data may be surprising. In comparison with the main trading partners (in the aggregate), German unit labor costs (measured in national currencies) have increased only two times since the 1970s (1970/1971 and 1992/1993). Over the years (indexed to 1970), a growing gap – or competitive advantage – in favor of Germany has opened up. Measured in international currency, that is taking exchange rate changes into account, German unit labor costs rose somewhat faster in the 1970s. They then (1981) dropped below those of other countries, rising above them only twice during the 1980s and the 1990s (1987 and 1995) (Flassbeck, 1998; Deutscher Bundestag, 2002, p. 205). In the past few years, between 1997 and 2003, German unit labor costs rose significantly more slowly compared to most of the main trading partners, apart from Japan. This advantageous competitive position altered somewhat recently due to the appreciation of the euro, but without completely abolishing the gains of the previous years (Hein, Mülhaupt, & Truger, 2003; Wendl, 2002).

In contrary to the continuous lamentation about the German economy, Germany's competitive position for the long run remains very strong. With regard to unit labor costs, there is no visible decline whatsoever in competitiveness. Growing competitive advantages and trade surpluses against the accession countries in eastern central Europe have further strengthened this impression. Not even the strong appreciation of the euro has brought an end to the extraordinary export success so far. If unit labor costs exerted competitive pressure, then it was a temporary result of the asynchronous cyclical developments[6] of costs and – mostly – a result of changes in exchange rates (Flassbeck, 1998).

These results are less astonishing if Germany's export success is kept in mind – at least there is no theory that would explain how a country with supposedly enormous competitive disadvantages, as Germans are told incessantly, could be world champion in exports! Apart from a very few years, West Germany constantly realized trade and current account surpluses until unification (Herr, 1994). Then the current account – of entire Germany – became negative, whereas the trade balance remained positive despite the strong import suction of eastern Germany. Since 2001, the current account returned to the positive and in 2002 and 2003, export surpluses reached new heights (SVR, 2003; Bartsch et al., 2003). This export success is even more impressive when one looks at the structure of the current account. While trade in goods, supported by the ”star branches” of the automotive, chemical and mechanical engineering industries, chronically showed surpluses, occasional deficits of the current account resulted from transfers (e.g. international organizations, remittances), terms of trade effects, and deficits in services’ trade. The major negative part of the latter again results regularly from traveling (i.e. purchases of German tourists abroad) and to a smaller extent from high-grade services (Heise et al., 2000; Deutsche Bundesbank, 2001).

Notwithstanding this impressive strength of the German economy, two problems in the structure of trade have recently been expressed:

The continued weakness of eastern Germany: Because of the deficient industrial structure of eastern Germany, export success is the exclusive business of western Germany. In manufacturing, the export quota of eastern Germany in 2001 amounted to a mere 23% compared to 38% in western Germany. Regarding the share of the most dynamic branches, the relationship is similar (Deutsches Institut für Wirtschaftsforschung [DIW] et al., 2002; Priewe et al., 2002). This weakness, also expressed by a strongly negative regional trade balance (a *Produktionslücke* or production gap amounting to around one-third of eastern Germany’s GDP) financed by transfers, is not only caused by minor competitiveness but is also a result of the specific transformation process. Confronted with the massive competition of western producers and the high value of the Deutsche Mark (DM) after unification, eastern German enterprises aligned themselves with local markets, where competition was less intense.

A retarding structural change in the German economy: The strength of the German economy, as expressed by exports, is based mostly on rather ”traditional” branches, whereas the most dynamic research and development- (R&D) intensive products are more strongly represented on the import side of the trade balance. Therefore, a future decrease of export surpluses caused by the structure of trade is likely (Vogel, 2000; Bundesministerium für Bildung und Forschung [BMBF], 2001).

The latter phenomenon is at least partly rooted in the sectoral structure and the *innovation system* of Germany. As perhaps the most interesting issue concerning Germany’s competitiveness, the performance of the innovation system is discussed separately in the next section.

6. AN EXHAUSTION OF THE GERMAN INNOVATION SYSTEM?

In the 1990s, Frieder Naschold, then researcher at the *Social Science Research Center Berlin*, was one of the first to identify the insidious signals of a fading evolutionary capacity – albeit starting from a high level (Naschold, 1997, p. 19). Naschold explained this assessment of the sectoral structure by the high share of employment in manufacturing and a comparatively small share of services. Additionally, he found that the pattern of specialization of the German economy showed an underdevelopment within the field of high-tech products (e.g.

information technology, aerospace and aircraft technology) with an R&D intensity above 8.5% (share of turnover going to R&D-expenditures). By contrast, specialization advantages were concentrated in the field of medium-tech products (R&D intensity between 3.5% and 8.5%) and especially in automotive technology, mechanical engineering, the chemical industry, and electronics. This pattern of specialization was also reflected in the innovative capacities (e.g. patents, less innovative restructuring activities) and went along with smaller spillover effects and slower growth in dynamic sectors.

Later studies basically confirmed this assessment and ascertained a progressing concentration of innovative activities on the *System Automobil*, whereas the declining international advantages of the German innovation system (e.g. specialization, qualification) indicated an enormous need for structural changes toward young and sophisticated high-tech branches (BMBF, 2001; Meyer-Krahmer, 1998; Vogel, 2000). Although at the end of the 1990s a temporarily strengthened dynamic in high-tech branches took place also in Germany, and the strong international orientation of German companies was reflected in a leading role in triad patents, the overall weakness of the German and the European economies prevented more investments in R&D and qualifications. At the same time, the automotive industry's share of German innovation activities and trade with R&D-intensive goods further increased (BMBF, 2003).

If there really is such a thing as a decline in competitiveness, it is reflected more in innovative capacities and in the structural dynamics of the German economy and less in too-high labor costs. These difficulties might grow further since they are at least partly rooted in the institutional model. Additionally, demographic trends indicate a coming shortage of qualifications. But what are the implications of this assessment for an explanation of the current weakness of the German economy and for the future capacities of the German Model? Although the dynamic development of new technologies and high-tech branches has been seen as one causative factor of higher growth in the United States during the New Economy, declining innovative capacities can hardly be regarded as a major reason for Germany's enduring growth and unemployment problem (Becker & Vitols, 1997; Boyer, 2003).[7] Firstly, the exceptional dynamic of new high-tech branches was a success story of the New Economy at a point in time when Germany's problems had already surfaced a couple of years earlier and were then exacerbated by other factors such as unification. Secondly, despite the indicated deficiencies, most studies attest Germany to have maintained a highly competitive innovation system. Germany holds a leading role in several key technologies, for example, environmental, energy and traffic technologies (Vogel, 2000). Moreover, as the trade balance shows, the competitive *and* innovative success (exports) of the traditional "star branches" has more than compensated for the deficits (imports) of the high-tech branches.

As mentioned above, the latter fact may alter in the future. The question remains whether a fundamental change in the German innovation system would be advisable or even necessary. This question again leads back to the discussion about different models of capitalism and the peculiarities of the German Model. In the institutional literature and especially in the *varieties of capitalism* approach, innovation systems are conceptualized broadly. As an integral part of the whole national model, the innovation system not only consists of the educational and training system and the organization of (private and public) research and development, but also is closely linked with (or embedded in) other institutional forms and modes of coordination, such as finance, industrial relations, or corporate governance (cf. Becker & Vitols, 1997; Hall & Soskice, 2001). In general, liberal market economies are considered to be more dynamic and flexible in the short run and therefore better equipped to motivate, develop, and utilize high-tech innovations at the forefront of technological development. The reasons therefore are seen, for example, in less regulated labor relations, the relevance of more flexible capital markets, incentives in the educational system and in employment relations, and less regulated product markets (cf. Soskice, 1997).

In consequence, these economies not only obtain the higher growth dynamic of young innovative enterprises and branches but also gain what are termed ”first-mover advantages” in international competition. By contrast, the German innovation system is characterized mainly by reliable adaptability in the long run in conjunction with a high ability to integrate established technologies in new high-quality – but rather medium-tech – products. In a stylized way, the former’s ability to produce *radical innovations* is contrasted with the latter’s ability to engender more continuous and stability-enhancing *incremental innovations* (Soskice, 1997; Becker & Vitols, 1997).

The concept of institutional complementarities (see the next section) provides some good reasons to question not only the feasibility but also the necessity of an institutional switch to an Anglo-American type of innovation system – even if the recent dynamic of radical innovations continues. As the lasting international success of traditionally strong industries indicates, the German innovation system still works quite well and internal complementarities are by and large intact. While there is no doubt that some elements or trends could be improved, for example, concerning the creation of qualifications or the links between different spheres of research, there seems to be more of a (temporary?) disproportion between external dynamics and the innovation system rather than an internal erosion of the latter (cf. Boyer, 2003; Beck, 2002a). This is a question about the advantages and disadvantages associated with the different options. In contrast to an imitation of the Anglo-American model, the careful and path-dependent alteration or rearrangement of existing institutions combined with the importation of lacking capacities could preserve existing comparative advantages instead of gambling with them. As the example of biotechnology development in Germany showed recently, this not only is a successful strategy but also increases the capacities dealing with radical innovations (cf. Casper, 1999; Harding & Sorge, 2000). Moreover, with regard to long-term development, the capacity of the German innovation system to change and adapt is generally assessed very positively and even superior to the Anglo-American model in the – less turbulent – ”maturation phase” of key technologies (Yamamura, 2003; Boyer, 2003):

> ”What Germany has been better at is to diffuse an innovation once it is beyond the more elementary stages, achieve high penetration and generate benefits through customised and piecemeal continuous adaptation.” (Harding & Sorge, 2000, p. 119)

In consequence, even if temporary relative weaknesses are taken into account, there exists no general, let alone dramatic, decline in competitiveness of the German economy. In relation to the situation of costs, trade, and the innovative capacities, a presumed loss of competitiveness cannot explain the pertinacity and the extent of growth deficits and unemployment. Indeed, Germany's problem seems not to be a lack of competitiveness but rather the lacking ability to convert high competitiveness into growth and employment.

In sum, the microeconomic interpretation and in particular the incrustation thesis are not satisfying. As concerns the historical fit, the relevance of several causative factors, and the assessment of institutional contexts, the microeconomic view provides a rather hypothetical patchwork of partial arguments instead of an explanatory framework. However, at least as a justification for a far-reaching deconstruction of the German Model, a convincing assessment would have to be asked for, otherwise the causal links between existing problems and suggested reforms are questionable.

7. ENDANGERING INSTITUTIONAL COMPARATIVE ADVANTAGES

In the debate about the *varieties of capitalism,* much emphasis has been put on institutional *complementarities*, which means that specific institutions have to be seen – in a rather holistic way – as integral parts of an institutional system, their relevance being related to the existence and operation of other institutions. Institutions in this concept are to a certain degree mutually reinforcing (*increasing returns*) and have to be compatible with each other regarding their modes of coordination. On the other hand, it is supposed that altering singular institutions could be problematic or even counterproductive, because this could reduce not only possible synergies but also the functioning of these and other institutions (cf. Hall & Soskice, 2001; Amable & Petit, 2001; Boyer, 2002).

This approach is useful for assessing in what ways the recommended reforms might prove dysfunctional to the overall design of the German Model. From this point of view, the suggestions of the OECD survey are not marginal. On the contrary, being theoretically consistent, the several measures utilize the aspect of complementarity, too. If there exists a "historic-materialist" substance that gives meaning to the notion of different models of capitalism, that is the existence of different, more or less coherent, institutional arrangements operating with specific modes of coordination, then the suggestions of the OECD and other similar assessments (e.g. by the German Council of Economic Experts) also favor a specific model, namely a *liberal market economy*. Although those models are (often) at first the result of theoretical assumptions, they are also related to existing national capitalisms and (try to) draw much of their legitimacy from empirical comparisons and national examples. Nowadays, there is widespread belief that *liberal market economies* or the *Anglo-Saxon* type of capitalism is better equipped for and more compatible with the requirements of globalization than *non-liberal,* also called *coordinated, market economies* and among them *Rhenish* capitalism (cf. Streeck & Yamamura, 2003; Harding & Paterson, 2000).

The question at hand here is not so much about the convergence or divergence of different models, but more fundamentally about different or even conflicting modes of coordination. Under the concept of complementarity, this differentiation is not merely of academic relevance, because then reforms could be hazardous, in particular when they would alter the mode of institutional coordination. The question is therefore not only about the comparative advantages of different institutional forms but also about the chance of success of an institutional alteration. Even if specific regulations (e.g. regarding corporate governance) are successful in theoretical models or in a given national institutional framework, it is quite uncertain whether the same regulations would operate with similar success in a different or ”adverse environment” (Jürgens et al., 2000). Moreover, the implementation could hamper the operation of other institutions (Hancké & Callaghan, 1999; Kogut, 1997). In the case of Germany, for example, the lowering of dismissal protection or the weakening of codetermination could undermine the *Produktivitätskoalition* (productivity coalition) between labor and capital, which is the basis for *diversified quality production* and enduring export success (cf. Herr, 1994; Harding & Sorge, 2000; Hollingsworth, 1997).

According to Hall and Soskice (2001, p. 8), in *coordinated market economies*, like Germany for example, firms depend more on non-market modes of coordination, relying on relational or incomplete contracting, network monitoring, and collaborative relationships. Economic outcomes ”are more often the result of strategic interaction among firms and other actors”. By way of contrast, in *liberal market economies*, like the United States, firms' activities are primarily coordinated via competitive market arrangements, hierarchies, and formal contracting. Outcomes are the result of supply and demand decisions according to price signals and are often based on rather short-term, marginal calculations. Although elements of the latter are not completely absent in the former, a consistent application of liberal market-style concepts, as presented above, would imply a significant alteration of the German economy and would possibly overcome the German Model. While change could generally follow two different directions, that is the deepening or strengthening of existing complementarities and comparative institutional advantages according to the prevailing mode of coordination versus the weakening of this mode of coordination in favor of a different one, recent trends as well as the majority of current reform proposals are in favor of the latter alternative.

Since neither the operational stability nor the real economic and social outcome of those reforms is certain or even predictable, it should be questioned whether there are indeed no alternative explanations and strategies as popular rhetoric often affirms.

8. THE OPERATION OF GERMAN MERCANTILISM[8]

So far, I have conceded much room to the discussion of the paradigmatic microeconomic view and widespread arguments of corresponding contemporary discourses. Now I will present a different view on Germany's economic development, which takes ”systemic” peculiarities and historical alterations of the

German Model and its interaction with its environment into account. In contrast to the microeconomic view, the focus here lies on macroeconomic, (macro)institutional, and political relations. The constant ”variable” within this explanatory framework is German *mercantilism,* not only as an economic phenomenon but also as a politico-economic *strategy* (Herr, 1994). Therefore, the concept of mercantilism is particularly useful for detecting factors that help to explain Germany's historical transformation from an admired model to a chronic patient.[9]

As already stated, since the 1950s Germany has continuously recorded trade surpluses and, apart from a few years, also a surplus of the current account. Besides these surpluses, a second constant factor in Germany's economic history during (most of) this time was an extraordinarily low inflation. In particular, since the 1970s and during both ”oil crises”, inflation in Germany was significantly lower than in other countries. The consequence was a continuous undervaluation of the Deutsche Mark (DM) or, more precisely, a *real* undervaluation in terms of *purchasing power parities* despite *nominal* appreciations (Crouch, 2000). In spite of some supportive external factors, particularly expanding world markets, the export boom in the wake of the Korean War, and international tolerance for an undervalued DM, trade surpluses and low inflation have not been fortunate coincidences but rather the results of economic policies and the high social value attached to them.

Low inflation, that is slow increases in the general price level, as an important precondition for high competitiveness and export success was, in Germany, the result of a – nearly textbook – cooperation of various institutional, political, and socioeconomic factors. The German Bundesbank, owing to Germany's somewhat paranoiac aversion to inflation ever since the hyperinflation of the Weimar Republic, enjoyed high constitutional and political independence. With continuing success (i.e. low inflation, international confidence, and a high currency premium of the DM) and a hoarding of foreign currency as a consequence of current account surpluses, the Bundesbank attained an unassailable status in the public eye (Altvater, 2001). The Bundesbank not only pursued the goal of low inflation consistently but also facilitated the realization of current account surpluses and reacted rigorously to (imminent) deficits. However, the Bundesbank did not promote exports by the classic mercantilist strategy of devaluation. On the contrary, this was categorically rejected. Instead, it pursued a course of monetary stabilization and restrictive policies regarding interest rates and monetary aggregates. The capital inflows (which usually have an expansionary effect on monetary aggregates, the economy, and eventually on inflation) caused by the current account surplus and the increased currency premium of the DM were sterilized as far as necessary (and possible). In ”critical” situations regarding monetary stability, as in the early 1980s, the Bundesbank refused to accommodate an expansionary fiscal policy and furthermore did not eschew a stabilization crisis and conflicts with the government.

The second stabilizing factor is based on the system of industrial relations and the German production model. Highly institutionalized corporatist industrial relations canalized conflicts and provided the infrastructure for strategic and cooperative behavior, long-term adaptability, and the *Produktivitätskoalition* (productivity coalition) crucial for the operation of the production model. According to Post-Keynesian theory, the development of unit labor costs is the most important factor determining the general price level or inflation. In the case of Germany, comparatively moderate nominal wage increases and high productivity resulted in low increases of unit labor costs and hence low rates of inflation and high international competitiveness – even in times of a nominal appreciation of the DM, that is a real undervaluation (cf. Crouch, 2000).

Finally, the third pillar of German mercantilism concerns fiscal policy. Fiscal policy has never been particularly expansive except during the early 1970s. But even then, the resulting level of public indebtedness in Germany still remained below that of many other industrialized countries. Nevertheless, this increase gave a bad name to any policy that would increase public debt. Since the early 1980s every German government has therefore pursued a rather restrictive fiscal policy regardless of the level of growth and unemployment or the special circumstances of German re-unification. Public indebtedness nevertheless kept rising, however, not as the calculated result of a deliberate strategy but rather inadvertently compounded by bad policies such as the ”monetaristic” currency reform and the privatization strategy of the *Treuhandanstalt* (Altvater, 2001).

In an environment of expanding world markets, fixed exchange rates, and asynchronous business cycles, German mercantilism worked quite successfully, combining current account surpluses with high growth and full employment. Seen as contributing factors of the economic miracle and the general rise of welfare, trade and current account surpluses as well as the stability of the DM almost took on a fetish character. But why did this wondrous formula lose its magic in the 1980s – despite persistent reapplication? Generally speaking, the answer lies in the combination of three kinds of developments, which are not entirely independent but rather partly reinforce each other:

(1) The mercantilist strategy is contradictory in its inherent logic and has problematic side effects.

(2) External conditions changed in a way that manifested the contradictory character of the strategy or simply reduced the likelihood of desired results.

(3) The reaction of the different actors in the form of an even stricter application of the several ”modules” of mercantilism under different conditions served to strengthen the contradictory moments and the negative effects. In consequence, the former ”lucky circle” turned more or less into a ”vicious circle”.

The first development is related to several logical or inherent, that is not accidental, consequences of a mercantilist strategy that undermine the strategy itself. First of all, realizing current account surpluses implies financing foreign consumption. Current account surpluses induce an inflow of income from trade or increased outstanding debts and domestic savings generated by foreign consumption. With regard to the *balance of payments*, this also implies (private) exports of capital and/or a hoarding of foreign reserves by the central bank and becoming an international creditor. In other words, the economy concerned produces more than it consumes. The often heard argument that Germans had been living beyond their means and now would have to ”tighten their belts” is therefore flawed. On the contrary, continuous current account surpluses indicate that German society gave up part of the goods it produced.

Secondly, current account surpluses lead to currency appreciations, which equal a loss of international cost competitiveness. If these are to be avoided, at least to their full extent of erasing the surpluses, then the government and the central bank have to pursue restrictive policies that curtail growth below its full potential. These restrictive policies, in turn, may intensify the pressure to appreciate, because the resulting high interest rates and low inflation make the currency attractive to foreign investors. The pressure may be further aggravated by the expectation of appreciation, since then investors can expect to make good not only on the higher real interest rate but also on the appreciation.

In the case of Germany, fortunately, the high trade surpluses did not translate in equally high current account surpluses because of deficits in the trade with services (cf. Story, 2000). However, the impact on domestic employment was nevertheless negative. Basically Germany traded capital-intensive goods such as automobiles for labor-intensive services such as accommodations in vacation resorts. Moreover, the fact that the full extend of trade surpluses is not expressed in the current account may encourage even more efforts at improving competitiveness.

In sum, the tendencies to appreciate ones currency and the risk of rising inflation create a continuous need for stability-enhancing policies – a tight monetary policy, moderate wage increases, or a restrictive fiscal policy – if the competitive advantage is to be preserved. The more vigorously this strategy of a ”stability-orientated undervaluation” is pursued, the more contractive the effects on domestic demand, investments, growth, and employment will be. As if that weren’t enough, more vulnerable, chronically deficit countries, particularly smaller countries, are coerced into pursuing a similar strategy. The result is a cyclical alignment and perhaps a downward spiral impelled by the competitive restrictions on demand and growth in several countries.

9. MACROECONOMIC FAILURES OF GERMAN MERCANTILISM

For several years, Germany was very successful with the strategy of export-led growth because, given the specific set of external conditions, positive effects had been large and it was possible to ”control” the countervailing tendencies. Beginning in the late 1960s, however, this relationship became more and more inverted due to a number of changes and trends:

(1) The starting point of this process was the destabilization and then abandonment of the Bretton Woods regime of fixed exchange rates in the early

1970s. The introduction of *flexible exchange rates* increased the pressure to appreciate the German Mark. The Bundesbank tried to dampen this pressure by restrictive monetary policies, which, in turn, led to stagflation. Struggling with the problems of stagflation and undesirable effects of capital flows on flexible exchange rates, monetary policy and fiscal policy alternately switched between a contracting and an expansive course. The result was a neutralization of expansive effects and a preponderance of restrictive effects at the expense of growth and employment. Realizing the uselessness of an expansive fiscal policy that is not accommodated by the Bundesbank, and pressed by the ”hysteria” surrounding rising public debt, fiscal policy turned to a consolidation course even before the political *Wende*[10] (turn-around) in 1982 (cf. Eicker-Wolf, 2003). In the 1980s, German mercantilism still worked and the current account surplus reached new, record-breaking heights – but now without having large expansive effects on growth and employment as under the Bretton Woods regime (see also Priewe, 2003; Heise, 2001).

(2) A second fundamental change in the 1980s and 1990s was the growing international competition and the emergence of other countries (Japan, Asian ”tiger” economies) pursuing strongly mercantilist strategies. Whereas earlier the expansion of world markets and global demand was large enough to ”nurse” one major mercantilist country (Germany), it now became problematic when a number of – not small – countries tried to grow by producing more than they were prepared to consume. Since this asymmetric strategy required countries with large current account deficits (e.g. United States), it had destabilizing effects on the global economy and restrictive effects on global demand and growth. The most prominent recent victim of this – its own! – strategy was Japan, which was caught in a ”liquidity trap” and suffered from deflationary tendencies and a ”paradox of thrift”, that is high savings at the expense of consumer demand and growth (Blecker, 2000; Palley, 1999).

For exporting German companies formerly accustomed to an oligopolistic behavior, rising competition even in the niches of diversified quality production meant that they increasingly became *price-takers* (Jürgens, 2003; Boyer, 2003). However, the consequence was *not* a general loss of competitiveness, as often claimed, but a *higher price* that had to be paid for staying competitive, which is necessary for maintaining the mercantilist strategy (cf. Brüggen & Peine, 2000). Some of these costs were shifted from the export industries to suppliers and subcontractors and indirectly – via taxes, low inflation, moderate wage increases, and the enforcement of increased productivity and flexibility – to the rest of the economy and society. The resulting burden, for example, the tax burden of *small and medium-sized firms* or the comparatively small increases in real wages and disposable income, has depressing effects on demand, investments, and employment (cf. AAW, 2003). Additionally, the privileging of the traditional export sector is perhaps more responsible for the slower sectoral dynamic than other institutional specificities of the German Model, such as industrial relations, labor market regulations, and the innovation system.

(3) The bringing together of the highly competitive, mercantilist West German economy with the non-capitalist, rather autarchic East German economy into one common economic and institutional entity had three major economic effects. *Firstly*,

for the western part, it created a welcomed surge in demand and thus a redirection of exports to eastern Germany. *Secondly*, the eastern German economy imploded with the consequence of deindustrialization and mass unemployment. In the convergence process that followed, eastern Germany attained two-thirds of western Germany's economic standards, with convergence more or less stagnating since the mid-1990s.[11] *Thirdly*, the intended equalization of living standards and the modernization of infrastructures had to be financed through large transfers from the West (including the European Union) to the East. These transfer payments – over 150 billion DM per year – have been raised by social insurances, rising debts of public bodies, (partly covert) funds, and, to a small extent, by additional taxes (*solidarity surcharge*) (Czada 1998; Beck & Greven, 2001).

Germany's present problems (e.g. high unemployment, public indebtedness, pressure on social insurances) are to a large extent the result of unification. Obviously, the above mentioned transfers cannot be maintained, but who will buy all the German exports in the future, and how great must the competitive edge therefore become? If the eastern German economy should become less dependent on transfers, this would imply that eastern German companies must gain market shares, also at the expense of western German companies. There is no doubt that this would be easier in a growing economy (Flassbeck, 1999).

The transfers also have a distributional side. They fall most heavily on low-income households and small, less-mobile enterprises (cf. Czada, 1998). Apart from the question of a just distribution, this has a depressing effect on overall demand (cf. Flassbeck, 1999; Altvater, 2001).

(4) Beginning with the *Maastricht Treaty* at the end of 1993, continuing with the *European Growth and Stability Pact* in 1997, the *European Monetary Union* (EMU) and later the *European Central Bank* (ECB) in 1999, and culminating in the introduction of the euro in 2002, the institutional and political conditions of macroeconomic policies have altered fundamentally. While wage policy and most regulations for the production model or the welfare state remained on the national or local level, monetary policy and currency became European. Additionally, strict regulations concerning (national) fiscal policy and public debt have been set (for details, see Çağlar's chapter in this book).

At first glance, the new conditions seem to be favorable for Germany (cf. Crouch, 2000). Given the competitive strength of the German economy and the operation of collective bargaining, the large European market – hitherto the major destination of German exports – should provide good opportunities for growth and employment. Moreover, because of the similarity in structure between the ECB and the German Bundesbank and the stability criteria of the pact, modest rates of inflation and a stable euro (but possibly without the constant pressure to revaluate) look as if they could even strengthen Germany' cost competitiveness outside the euro zone.

This scenario has proved true with regard to German mercantilism. In the second half of the 1990s, (western) Germany's competitiveness – measured in unit labor costs – steadily improved and, backed by an undervalued euro, the current account returned to surpluses. At the end of the decade, Germany once again became net creditor to the rest of the world, resuming a role it had played before huge amounts of capital were needed for eastern Germany's transformation (Reuter, 2000). Indeed, in 2002 and 2003, Germany's competitiveness was so pronounced that even the strong appreciation of the euro against the U.S. dollar failed to diminish record-breaking German exports.

Yet this impressive development had only little effect on growth and employment and at best prevented an even deeper recession. It is not without some irony that Germany had been the main proponent for European monetary constitution and fiscal restraint (cf. Story, 2000), which now have emerged to be a macroeconomic problem for Germany in particular. The constitutional design of the ECB and its refusal to take responsibility for growth and employment (Crouch, 2000; Watt & Janssen, 2003) not only limit expansionary dynamics in the European economy, but also render the German strategy to improve competitiveness dysfunctional (and vice versa). Low nominal wage increases in Germany put a damper on consumer demand and are responsible for low inflation. Given the ECB's extraordinarily low inflation target for the *European* economy (Watt & Janssen, 2003), even lower inflation rates in Germany result in higher *real interest rates* compared to the euro zone (Bartsch et al., 2003) and increase the risk of *deflationary* processes (Horn, 2002; Flassbeck & Maier-Rigaud, 2003).

The second channel, fiscal restraint, is also problematic, particularly in the German case. Although higher public debt would make sense in light of the enormous task of transforming eastern Germany and the weakness of monetary stimuli during a recession, German governments are hindered from using this option – if not by economic theory and/or the European Commission, then at least by public discourse within Germany. Irrespective of the appropriateness of (at least temporary and used for investments) higher debt, the threat of a so-called "blue letter" from the European Commission is generally discussed as a failure of government (cf. Flassbeck, 2002a; 2002b). On the contrary, even in times of sluggish private demand, rising private savings, and a lack of private investments, the consolidation of public finances *and* the reduction of taxes – again, in the name of competitiveness – are seen as the major objects of fiscal policy. The fact that this undertaking cannot work is simply ignored (cf. Heise, 2001).

Taken together, nearly all actors and policies reacted to the decreasing macroeconomic pay-off of German mercantilism with intensified attempts to increase competitiveness, thereby creating a macroeconomic environment that oppressed growth and even aggravated the problem of unemployment (cf. Bofinger & Flassbeck, 2002a; Hein et al., 2004):

(1) After a steady decline in the wage share of total income, wage policy became even more restrained in the second half of the 1990s. In the (vain) hope of trading wage increases for more employment, wage increase stayed steadily below productivity gains and inflation (Bartsch et al., 2003; Flassbeck & Maier-Rigaud, 2003).

(2) A tight and – in the case of too high interest rates – hesitant monetary policy by the Bundesbank and then by the ECB kept inflation low but also burdened indebted firms and retarded investments and growth (Bartsch et al., 2003).

(3) The primary goals of fiscal policy have been the consolidation of public finances, with negative effects on public demand, investments, and employment, and the reduction or even abolition of taxes (e.g. wealth tax). Reduced tax revenues as a consequence of tax cuts and slow growth raised the pressure to cut expenses and thus created a vicious circle (Flassbeck, 1999; 2003a).

(4) Cuts in the welfare state for the purpose of consolidation (Grell et al., 2002) have reduced incomes and consumption in low-income households.

(5) Motivated by the risk of unemployment, reduced employment protection, and the reduction and privatization of pensions, private households increased their savings at the expense of consumption (Flassbeck, 2004). In the end, all the reforms have made the population feel uneasy about the future and thus hesitant to spend their money now (Horn, 2003a).

10. CONCLUSION: RED-GREEN REFORMS: AN APPROPRIATE RESPONSE?

At the beginning of the new century, the state of the German economy is ambiguous: On the one hand, highly competitive and – in terms of exports – outperforming the rest of the world; on the other, plagued by high unemployment and lagging behind in terms of growth. Moreover, recent projections did not foresee a betterment. In the coming years, growth rates are expected to reach two percent at best – too low to reduce unemployment significantly. Sectoral dynamics and the emergence of the so-called ”information society” will not be strong enough to make up for the jobs likely to be lost in manufacturing. Relief for the labor market as a result of demographic trends is not expected until 2015, but the aging of the population could already impair the operation of the labor market, that is the structure of available skills. This scenario is unlikely to be altered by migration in the wake of the European Union’s enlargement. The estimated immigration is not large enough to have significant effects on jobs and wages, nor can it counteract the demographic trends (cf. Beck, 2002b).

Nevertheless, the present Red-Green government persistently affirms that reducing unemployment is a matter of appropriate reforms and a restructuring of the welfare state according to the requirements of globalization. Without reproducing what is discussed in other chapters of this volume (e.g. about the welfare state, the tax system or industrial relations), in this last section I will assess the basic impetus of Red-Green reforms concerning growth and employment, and in particular concerning the labor market. The predominant question here is whether the current reforms will reduce unemployment as extensively as promised.

After a short episode of rather traditional social democratic policies, in 1998 the Red-Green government adopted supply-side economic policies (see Beck and Scherrer's chapter in this book). In particular, fiscal policy was dominated by the goals of consolidation and tax cuts (Truger & Jacoby, 2002). Although tax reforms were expected to have an expansionary effect on private consumption, this effect never materialized. For one, it was neutralized by counteractive policies, for example, rising contributions for health care, pensions, and the new *eco-tax*. Furthermore, tax reforms favored high-income households and large corporations, not low-income households whose propensity for consumption is relatively much higher than in the other households (cf. Schratzenstaller, 2002; Schumann, 2002). In the end, reduced tax revenues as a consequence of sluggish growth and tax relief counteracted the consolidation endeavors and aggravated the financial problems of local governments in particular. The crisis of local public finances led to a dramatic curtailment of public investments with detrimental effects on job growth (Heine, 2004; Truger & Jacoby, 2002).

A second general goal of Red-Green was the enhancement of competitiveness by lowering labor costs. For example, the revenues from the new energy tax (*Ökosteuer*) are used for reducing non-wage labor costs, not for ecological projects (Truger & Jacoby, 2002). A further attempt to enhance competitiveness was to limit wage increases, that is encourage moderate wage agreements, with the establishment of the *Bündnis für Arbeit* (see also Fichter's chapter in this book). Although this alliance for jobs had few concrete results, this kind of corporatism helped to discipline unions and to establish the belief in a trade-off between wage increases and employment (cf. Niechoj, 2002; Heise, 2002).

The most important reforms attempting to reduce unemployment concern the operation of the labor market and the structure of the welfare state. Starting with the so-called *Job-Aqtiv-Gesetz* in 2001 and then reinforced by the concepts of the *Hartz Kommission* (2002) and the *Agenda 2010*, Red-Green labor market and social policies followed the ”doctrine” of *Fördern und Fordern* (incentives and demands), as formulated in the Schröder/Blair paper of 1999 (cf. Brütt, 2003). According to this strategy, unemployment should be reduced by a combination of three elements: The creation of new – mostly low-income – jobs (e.g. *Mini-Jobs*, *Job-Floater*) and the promotion of self-employment (e.g. *Ich AG*, i.e. *Me Inc.*) by subsidization, increased incentives, or coercion to take up work (e.g. acceptability requirements, eligibility regulations of unemployment insurance), and the improvement of job placement efforts (e.g. Personal Service Agencies). Additionally, a lowering of unemployment benefits, a restriction of dismissal protection, and the promotion of firm-level alliances are ingredients of the Agenda 2010 (cf. Herr, 2002b; Bartsch et al., 2003).

While the Schröder government, following the Hartz report, alleged that the implementation of these reforms would halve unemployment in a few years, critics expect at best a small reduction in unemployment. Since the reforms altogether follow the neo-classical conception of the labor market and the incrustation thesis discussed above, it is more than questionable that millions of new jobs will be created in this manner (Herr, 2002b; AAW, 2003).

Given the low – and partly even declining – private and public demand, there are no convincing reasons why enterprises should increase their demand for labor and reduce productivity simply because labor is somewhat "cheaper". In a highly competitive and almost deflationary environment, a decline of prices and incomes would be more likely (cf. Bofinger & Flassbeck, 2002b). To avoid a downward spiral of declining demand and rising unemployment, demand would have to grow (cf. Horn, 2003b). In the logical world of neo-classical models, such problems do not exist because when wages fall, employment rises simultaneously. Hence, using an intertemporal model, current reforms are premised on a strange mechanism: Not hoping, but *knowing* that they will get a job and a higher income in the (near) *future* as a result of the reforms, the unemployed increase their expenses *today* and create the necessary demand. As it is precisely these households that have the lowest or no savings and usually have problems obtaining credit, this scenario is very unlikely. Thus in the real world, the link between wages and employment is much more complex.

All in all, as illustrated by the discussion above, Red-Green economic policies are characterized by the same problem: Despite a successful enhancement of competitiveness, a significant reduction in unemployment is unlikely. Taking into account the tight monetary policy of the ECB and moderate wage increases, mercantilism still prevails. But what are the consequences for the German Model? According to the above assessment, the answer can only be ambiguous. With regard to recent trends concerning the production model, corporate governance, the financial system, and labor relations, most studies see a kind of *hybridization* that mixes elements of the German Model with elements of the Anglo-Saxon model of capitalism (e.g. Jürgens, 2003; Boyer, 2003; Jackson, 2003). Even if this assessment is plausible, it is unsatisfactory concerning the question of an *exhaustion* of the German Model. In view of the competitive capacities and the long-term adaptability of the German Model in a global economy, there is no cause to talk of exhaustion. Moreover, as Keynesian economists argue, the size of the European economy should provide enough room for maneuver for coordinated macroeconomic policies to strengthen internal growth factors and to reduce dependence on exports (cf. Bartsch et al., 2003; Heise, 2001). In addition, taking the ecological and natural limits of growth into account, future productivity gains could be used to reduce working times and the wastage of natural and societal resources (e.g. unemployment). It goes without saying that the room for maneuver would increase if the economic burden resulting from unification could be abolished.

Such a development would however entail or presuppose Germany's about-face from the mercantilism of recent decades. If the above argument of an exhaustion of the macroeconomic potential of German mercantilism holds, then an assessment of the German Model must of necessity come to ambiguous conclusions. If mercantilism is seen not only as a phenomenon and politico-economic strategy, but also as a constituent feature of the German Model, then the consequences would be two-fold. Firstly, one would have to assume a specific, macroeconomic exhaustion of the German Model; secondly, this begs the question of whether German socioeconomic institutions can be adapted to a non-mercantilist strategy. With the exception of necessary changes at the European level (e.g. concerning the ECB or the Stability Pact), this question must remain unanswered.

Putting these questions and the chances for a coordinated European macroeconomic policy aside and supposing instead the question were about *surviving* globalization, as we asked in our title, then the answer would be less optimistic. Looking at recent trends, current reforms, and public as well as academic debates, an onward deconstruction of the German Model is more likely. The faded capacity of the mercantilist strategy to provide growth and employment is taken as a reason to intensify efforts to improve competitiveness, rather than as a reason to question the strategy itself. As a consequence, Red-Green reforms in particular – in the absence of fundamental opposition – have created or deepened ”cracks” in the German Model, especially in terms of the models' inclusiveness and the enforcement of cooperative behavior (see Beck and Scherrer's chapter in this book).

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NOTES

[1] Of course, because of the dual structure of German industrial relations, at plant level the role of a co-management was mainly taken over by individual work councils. With regard to their explicit readiness to wage restraints, their engagement in regional and industrial policy, and also – in some cases – direct interactions with large companies (e.g. Volkswagen [VW]), unions, too, indirectly adopted similar functions.

[2] The theoretical legacy of John Maynard Keynes has spawned a number of theoretical strands. In the 1960s and 1970s, a simple version of the so-called ”Neoclassical Synthesis” and the IS-LM model, developed by J. Hicks, F. Modigliani, and later P. Samuelson, became a widespread concept of economic policy. Nowadays these concepts have given way to two fundamentally different strands. The first, ”Neo-” or ”New” Keynesianism, is based on the neo-classical micro-foundation and more or less reduces Keynesian ideas to short-run rigidities (e.g. prices, quantities, labor markets). The second – heterodox – strand, often labeled as ”Post-”, ”Monetary”, or ”Financial” Keynesianism, rejects the neo-classical methodology and especially emphasizes the specific role of uncertainty, money, historical time, and institutions (cf. Herr, 2001; Eicker-Wolf, 2003).

[3] The OECD is a politically and academically respected ”think tank” and a forum for the developed countries. The surveys are drafted by the OECD's Economics Department and then modified by the subsequent discussions of the Development Review Committee. The latter is made up of the 30 member countries and the European Commission.

[4] Although those assessments are typical for a microeconomic view and moreover for the current fashion of benchmarking, I will not discuss them here because their effects on growth are hard to measure and are founded in the basic theoretical framework.

[5] Seignorage is the difference between the value of money and the cost of its production. In the classic example, the sovereign holds the exclusive right to create money and thus profits from minting coins that cost him less to produce than their face value. Since the United States bring the dollars into circulation they are able to buy foreign goods, services and assets nearly cost-free as long as the notes

remain overseas. Furthermore, in (Post-) Keynesian theories, a hierarchy of currencies is assumed in which every currency has a "currency premium" (similar to the Keynesian "liquidity premium") that expresses its stability, international diffusion and the confidence of economic actors. Besides the size of the U.S. economy, the high currency premium of the U.S. dollar is an important factor enlarging the room for maneuver of the Federal Reserve Board in monetary policy. By contrast, the tight monetary policy of the European Central Bank was at least partly motivated by the goal to establish confidence and a high currency premium for the new euro.

6 Changes could appear to be dramatic in the short run depending on the starting point and the number of years looked at.

7 Surely, with regard to the comparatively small extent of services, retarding sectoral change can be seen as a reason for low employment. What is mostly meant here is a slow expansion of less-qualified, less-productive or personal services (cf. Deutscher Bundestag, 2002, p. 210). These services are hardly related to the innovation system and high-tech branches and therefore not further discussed here.

8 The term "mercantilism" is primarily used to describe the politico-economic concepts and practices first of all applied in central and western European, mostly absolutist, states or societies between the 16th and the 18th century. In these strongly planned economies, the major aim was to increase the wealth of the sovereign ("L`Etat c`est moi") and of the state as an entity by a surplus of the trade balance. Means to this end have included tariffs on manufactured goods, subsidies, trade monopolies, and privileges. Recently, the term mercantilism, or also "neo-mercantilism", has been used to describe strategies and attempts to realize surpluses in the trade balance or the current account by export promotion and/or competitiveness-enhancing measures, such as currency devaluation or low wages.

9 The discussion here is based primarily on the work of Hansjörg Herr (1994), professor at the Berlin School of Economics, and the contributions of Heiner Flassbeck (see http://www.flassbeck.de/), a former Deputy Finance Minister of Germany and currently a Senior Economist at UNCTAD in Geneva. It goes without saying that there are other heterodox explanations, for example, about the crisis of Fordism. These other concepts are not called into question here and are useful to explain several phenomena that are discussed elsewhere. The intention is rather to highlight a specific moment in the German Model.

10 Growing disagreement between the Social Democrats (SPD) and the Liberals (FDP) over economic policies led in 1982 – after the programmatic and provocative "Lambsdorff" paper – to the breakup of their coalition and the so-called "Wende" (turn-around) when the conservative Kohl government came to power (Schiller, 1990).

11 The abrupt end of the German "unification boom" was also due to the restrictive monetary policy of the Bundesbank in 1992/1993 and repeatedly in the following years. There is some debate as to whether high interest rates in the first years after unification were the mistake of the Bundesbank (cf. Flassbeck, 2003b) or necessary to attract capital for financing unification (Czada, 2002). However, operating as de facto central bank for the EU (Story, 2000), the Bundesbank forced other European countries to follow suit. The consequences have been the european currency crisis in September 1992, followed by the collapse of the fixed exchange rate system in August 1993, and depressing effects on the whole European economy (Altvater, 2001).

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Chapter 4

FRANK KLOBES

THE DYNAMICS OF INDUSTRIAL RESTRUCTURING

1. INTRODUCTION

The 1990s witnessed a decisive change in corporate strategies at the heart of *Modell Deutschland* (German Model), that is export-oriented industrial enterprises. The changes were driven by the constraints and opportunities of globalization made technologically feasible by the digital revolution. They encompassed vertical disintegration, outsourcing and contract manufacturing, the implementation of company internal market relations, and a stronger focus on shareholder value. The impact of these new corporate strategies went beyond the corporations implementing them. For one, the new strategies had a direct effect on many supplier firms in other industries. In addition, as the most profitable and technologically advanced companies, these export leaders traditionally set the standards for the bulk of the economy in terms of production methods, industrial relations, wages and work conditions. Although they battled their respective unions many times, for the sake of industrial peace and productivity they were the champions of social partnership and home to the most advanced forms of codetermination. In this chapter, I will analyze the dynamics behind the process of industrial restructuring and trace its impact on the "German Model".

2. INDUSTRIAL STRUCTURES, FACTORS OF CHANGE AND IMPACTS

The "German Model" is often characterized by three elements. Firstly, there is a broad industrial basis with a strong export orientation combined with an institutionalized occupational education system that produces highly skilled workers (*Facharbeiter*). Secondly, there are guidelines for equitable living conditions based on strong federalism. Thirdly, there are substantial and autonomous collective bargaining relations between consensus-oriented and strong collective bargaining partners that are often referred to as the model of *Sozialpartnerschaft* (social partnership) (Heinze, 1998, p. 86).

In comparison to other advanced capitalist countries, Germany has a stronger industrial base and a less developed tertiary sector (service sector).

S. Beck, F. Klobes, C. Scherrer (Eds.), Surviving Globalization?, 69—92.

Although there is a trend toward tertiarization of the economy, the restructuring process in Germany goes slower than in other comparable countries. The value-added rate of the entire economy is still just below 40%, compared to just above 20% in countries like the United States, Canada, the Netherlands and Sweden (Keim et al., 2000, p. 101). During the last decades, millions of jobs in the industrial sector were lost and replaced by new jobs in the tertiary sector. The United States reached its peak of employment in the industrial sector in the mid-1950s; Germany, on the other hand, didn't reach its peak until the 1970s. From the mid-1970s through the mid-1990s, approximately six million jobs were created in the tertiary sector in the western part of Germany. The strongest increase in employment took place in the industrial service sector, where 1.2 million jobs were created between 1976 and 1994, for example, in the area of software, R&D, construction, design, technical planning, consulting and market research (Heinze, 1998, p. 87; Keim et al. 2000, p. 102).

Another characteristic of the German industry is the dominant role of large companies, in particular of the automotive, steel, chemical and engineering industries. In 1980, more than 3.6 million people worked in firms with more than 1000 employees. About 0.8 million worked in medium-sized companies with 500 to 999 employees, and around 1.8 million worked in companies with 100 to 499 employees. The large companies were strongly export oriented and relatively deeply integrated in the international division of labor. Additionally, their internal structures were organized and controlled by a central hierarchy, and the organization of production was strongly vertically integrated. Since the 1990s, German industry has come under mounting pressure for change. The politically forced liberalization of world trade accelerated the globalization of the financial market and in the sphere of production. The demise of the so-called "socialist" countries and the opening of the Chinese and some Southeast Asian markets meant new geographical locations for production and distribution. International automotive and high-tech industries in particular set up production sites in these countries. This set the stage for the global problem of overcapacity of production in many sectors because the markets in the advanced capitalist countries were saturated while the industrial markets in the former socialist countries did not develop as expected. What remained was dramatically intensified international competition and the need for corporate restructuring.

The structural characteristics of German industry mentioned above were the reason why the German economy and large companies in particular were heavily affected by globalization and corporate restructuring. Between 1989 and 1996, almost one-third of all jobs in firms with more than 1000 employees were lost, whereas the employment situation in the sector of smaller and medium-sized companies remained relatively constant (Deutsches Institut für Wirtschaftsforschung [DIW], 1998, p. 15).

The process of corporate restructuring caused by heightened international competition was streamlined by the digital revolution. Market requirements combined with new technologies led to accelerated product cycles and extended and diversified product ranges. The restructuring of the industrial base proceeded in two ways. The new rationalization strategies were not only directed toward increased internal efficiency but also expanded to the entire value-added chain. This double effect of “systemic rationalization” aimed at loosening and economizing all internal processes, production, labor organization, and the relationship between focal companies and suppliers (Altmann, 1986, pp. 191-193; Sauer, 1992, pp. 49-51). With this strategy, large companies wanted to shift market risks to the suppliers, in addition to meeting the market contingencies brought on by a new competitive situation, altered consumer behavior, and an increasingly unsteady and segmented purchasing power. The effects of the processes of restructuring and globalization on German industry are elusive. The large companies are less vertically integrated because of outsourcing and the focus on core competence. Because of an increasing internationalization of production, the integration into the international division of labor has deepened, not only for the large companies but above all for medium-sized companies with high-quality products, that is automobile suppliers and engineering companies. The implementation of competition at all corporate levels – on the shop floor, between cost centers, business units and different plants – results in global competition reaching every part and employee and consequently exerting pressure on existing industrial relations and codetermination.

3. CORPORATION MODELS AND STRATEGIES

During the last decade, company structures and the organization of production and labor have changed with lasting effect. Digital technology has played a key role as the backbone of this transformation. Mergers and acquisitions, global cooperation and expansions are both expressions and drivers of intensified international competition. Against this background and inspired by the Silicon Valley InfoCom industry at the end of the 1980s, a paradigm change has taken place in the main branches of industry. The focus of interest lies in the automotive, electronics and communications industries in particular. Intensified competition has raised the requirements for all corporate actors. Permanent cost reductions through economies of scale, setting up of new home markets through decentralization and transfer of production and other corporate functions, expansion and flexibility of product ranges (economies of scope) and accelerated innovation and product cycles (Hirsch-Kreinsen, 1998a, p. 20) require the mobilization of all capital and human resources. Under the premise of increasing productivity and profitability, the modern corporation concept expects a flexible, process-oriented company organization with flat hierarchies. A learning corporation with a market-adjusted and self-controlling organization is the goal (Bierbaum, 2000, p. 148).

The new paradigm of company activities is flexibility: flexibility of company structure, flexibility of production organization, flexibility of product range, and flexibility with respect to market requirements, workforce and customer wishes.

3.1. Globalization Strategies and Corporate Structures

Internationalization strategies of companies are in a period of change. Until the end of the 1980s, companies preferred either an export strategy in order to develop their market shares in different regions of the world or a multinational strategy, a company affiliation with branches abroad. Since then we have seen a shift in company strategies toward a global strategy and a transnational strategy. Frontrunners of this new development were Japanese companies in the electronics and automotive industries, which preferred to follow a global strategy. The global strategy is characterized by setting up production sites (transplants) abroad with worldwide standardized production and products, a reduced vertical integration, exploitation of regional and country-specific cost advantages, and by setting up global supply relations (Hirsch-Kreinsen, 1998a, pp.21-23). This global strategy uses, above all, the economies of scale effects. The transnational strategy however is characterized by a networked corporate structure with a strong regional connection with regard to product and production strategies; standardization, centralization of research and development (R&D) functions and procurement have a subordinate significance. The competitive advantage of this company strategy is market proximity, including the exploitation of regional, technological and labor resources with appropriate economies of scope effects. The motto of this strategy is “think global, act local” (Hirsch-Kreinsen, 1998a, p. 28). An equally important motive for the internationalization strategies of companies is the establishment of a dominant position in decisive market segments and world market regions. The tendency toward global oligopolization has led to the strengthening of market power with regard to standard-setting technologies and product configuration. Also, it offers possibilities for an even better use of economies of scale effects.

The decentralization of company structures and activities is often seen as a general trend and as a new historical stage of development (Hirsch-Kreinsen, 1998b, p. 38). The change in company strategies is also reflected in the production model of Wintelism[1], which describes the paradigm change from a Taylorist-Fordist-inspired model of production toward a model driven by digital technology (Naschold et al., 1999, pp. 2-5). In the first half of the 1990s, Michael Borrus and John Zysman articulated the concept of Wintelism. Together with developing cross-national production networks, Borrus and Zysman see Wintelism as the catalyst of structural changes in many branches of industry (Borrus & Zysman, 1997, pp. 1-3). The Taylorist-Fordist model of production was determined by hierarchical structures, a high degree of vertical integration and a high differentiation between specialized fields. The Wintelist model of production, by contrast, is characterized by the production line integration of functions, project-oriented cross-functional product development, transformation of processes by Inter- and intranet and by the decisive dominance of strategic component producers (Naschold et al., 1999, pp. 2-5). The high-tech industry of Silicon Valley is the birthplace of the Wintelist company model. It manifested itself in the second half of the 1980s, firstly, through a push of innovation, which introduced economical, networkable, microprocessor-based electronic products – the personal computers – to the market and, secondly, through massive outsourcing of services, which were transferred to contract services and contract manufacturers (Borrus & Zysman, 1997, p. 7; Lüthje, 2001a, p. 86). In this way, the former value-added chains were radically disintegrated, and highly segmented and flexible, horizontal and vertical value-added networks were created (Naschold et al., 1999, pp. 3-6; Borrus & Zysman, 1997, p. 2). The new form of vertical value added has its roots in the new relation between the final manufacturer (e.g. IBM, Compaq), the producers of key components (e.g. Intel) and the producers of operating systems (e.g. Microsoft). The market power has indisputably shifted toward the operating system producers, who possess the standard-setting technology (Borrus & Zysman, 1997, p. 8; Naschold et al., 1999, p. 6). If this model were to gain acceptance in decisive parts of the old economy, it would have far-reaching consequences for industrial structures and their hegemonic relations, particularly in the automotive industry.

The internationalization of company activities through mergers and acquisitions, the forming of cooperations and alliances, the setting up of new sites or the reduction of vertical integration through outsourcing of strategically unimportant activities all lead to global network corporations and aim at a high degree of strategic flexibility (Renneke, 2000, p. 20). Strategic flexibility means the setting up of flexible structures of production, product development and product architecture (modular systems), which put a company in the position to adjust quickly to new technology and market requirements in order to exploit the potential of flexibility and to gain high profitability and market chances. Leo Renneke considers alliance-forming to be the predominant strategy of globalization and finds the highest flexibility both in a strategic and in an operational sense in global network companies. Such companies enjoy the benefits of sharing technologies, resources and market advantages, yet in a relatively unbinding manner (Renneke, 2000, pp. 20-24). Margit Köppen sees two decisive drivers for international network-forming: foreign direct investments and the dismantling of value-added chains and outsourcing. Firstly, the setting up of new capacities or the acquiring others leads to a complex integration and restructuring of companies. This kind of network-forming can be characterized as an externally driven strategy of internationalization. Secondly, the outsourcing strategy or the dismantling of the value-added chain that leads to a kind of network-forming could be characterized as an internally driven strategy of internationalization (Köppen, 1999, pp. 85-86). Köppen views the "enormous increase of profitability that can be mobilised through advantages in firm sizes if certain product ranges can be concentrated at certain inner-company or external production sites" as the main reason for a continuing trend toward the internationalization of production (ibid., p. 86; translation: FK).

The forming of firm networks is usually associated with the decentralization of firm activities. Decentralization means the "segmentation of once central concentrated similar tasks and responsibilities and their outsourcing to newly defined organisational sub units" (Tullius, 1999, p. 66; translation: FK).

This theory of organization regards decentralization as the "outsourcing of competence of any kind of central firm unit to operating units" (Hirsch-Kreinsen, 1998b, p. 40; translation: FK). The purpose of decentralization is "to use the small organisational units', segments' or fractals' ascribed advantages of flexibility, costs and time also for greater firms to use without losing the advantages of size (economies of scale, synergies, capital equipment)" (Tullius, 1999, p. 67; translation: FK). Decentralization occurs on different levels. Three levels can be distinguished: a) the corporate organizational level; b) the factory organizational level; c) the work organizational level. The corporate organizational level is characterized by management holding structures, whose corporate units are primarily legally independent but closely linked with capital. At the factory organizational level, decentralization characterizes the reduction of hierarchies and the substitution of object-related structures through functionally related structures. The work organizational level includes among other things the implementation of teamwork, the optimization of internal company processes through a continuous process of improvement or self-organization concepts (Tullius, 1999, pp. 66-67). Contrary to Knut Tullius, Hartmut Hirsch-Kreinsen distinguishes only two kinds of decentralization – a strategic decentralization and an operational decentralization, which includes both factory organizational and work organizational decentralization. He notes structural changes for shifting competence to the level of production (reduction of hierarchies) and measures for reintegrating planning and operational work into a form of teamwork, quality circles and independent manufacturing places. Strategic decentralization refers to company units that are defined decisively by outsourcing and altered final producer-supplier relations (Hirsch-Kreinsen, 1998b, pp. 41-42).

3.2. Governance of Decentralized Firm Networks

Global, decentralized firm networks are complex organizations whose economical success depends on efficient governance. Core problems are the relationships of centralized control and autonomy and of cooperation and competition between the different firm units (Hirsch-Kreinsen, 1998b, p. 39). Consequently, the change from a Taylorist-Fordist to a Wintelist corporate model is associated with new forms of company governance and controlling. The earlier mechanism of control and governance was based on a distinct internal hierarchical structure with a direct and directive character. This, however, is completely unacceptable in a firm network that is decentralized on many levels. The decentralization of external and internal firm organization requires increasingly indirect context governance, the creation of internal organizational markets, and functional differentiation. Often, one finds matrix structures where a product- and market-related dimension is overlapped with a functional (e.g. production-related) or regional/national dimension of organization (e.g. division of branches) (Hirsch-Kreinsen, 1998b, pp. 43-46). The structuring of business units and profit and cost centers characterizes the internal level. This comparatively good selectivity of the firm structure is a precondition for the governance and controlling of the in-house and intercompany relations through the market mechanism. This enables the management to compare the performance of single firm branches and organizational units both inside the company and with those of the competitors. Strategic gains, targets of return on capital, continuous benchmarking, reference number systems and cost budgeting are the main tools of indirect context governance (Hirsch-Kreinsen, 1998b, pp. 45-46;

Pickhaus, 2000, p.7). Besides indirect coordination, managers use another method of coordination called the social integrative mechanism of coordination. This means above all new processes of communication, such as principles of consensus or bargaining processes for determining return on capital, cost and productivity targets for different branches, units, cost centers or teams. A new managerial role is also understood, as well as the development of a new corporate identity model or company-wide programs of rationalization with the assistance of employees (Hirsch-Kreinsen, 1998b, pp. 46-49).

The goal of implementing the internal market mechanism is to transfer the market pressure to different organizational units, right down to motivating each and every employee to act self-responsibly toward achieving higher economical company aims (Tullius, 1999, p. 67). Therefore, it is apparently not the management that generates constraints on continuous improvements and better product quality, but the market itself. Tullius distinguishes between a "true market mechanism", where certain company units are directly exposed to the market through outsourcing, and a "quasi market mechanism", where firm units and employees are subjected to market pressure by means of market-like internal governance mechanisms such as benchmarking and global sourcing (ibid.). The direct comparison of product costs and quality through implementation of the market forces leads to increasing and continuous pressure on costs and process optimization.

3.3. Dysfunctionality through Decentralization and Market Mechanism

The trend toward the decentralization of company structures and the implementation of the market mechanism in in-house work relations is not free of problems nor indisputable, however. The main problem at a company's structural level is between centralized control and decentralized autonomy, while the friction area with regard to the company governance mechanism lies between internal cooperation and competition (Hirsch-Kreinsen, 1998b, p. 51). Additionally, outsourcing, decentralization and network building can lead to a loss of core competencies (Tullius, 1999, p. 68). Renneke mentions another structural problem – the bigger and more diverse a modularly organized firm network and its units are, the more difficult it is to exploit the advantages of flexibility without losing effectiveness. For the effective realization of a modular company design, standardization of processes and patterns of interaction is necessary (Renneke, 2000, p. 3). Roland Springer suggests an interesting approach for striking a balance between flexibility and effectiveness. With the concept of "flexible standardisation", a best-practice method should be used for the continuous adjustment to a change of general conditions and requirements of products, production and markets that means to start up a process of standardization (Springer, 2000, pp. 104-105).

The creation of competition at the levels of corporate organization and corporate units or production sites often leads to counterproductive centrifugal forces. They can lead to technological, productive and work organizational barriers to innovation and loss of flexibility, because every unit sees the protection of its innovation as a competition edge over other corporate units or branches. This structural egoism, implemented through internal market forces, leads to the exclusive orientation toward one's own business success and endangers the cohesion of higher units and of entire firm networks. It is not uncommon that individual interests and the autonomy of single production sites or profit centers are predominant, which results in administrational mismanagement due to disregard for strategic decisions and flattering information being sent to headquarters. Cooperation and synergy effects are blocked and agreed targets are not met (Hirsch-Kreinsen, 1998b, pp. 51-52; Tullius, 1999, p. 68). "Discursive coordination" should play a role in coping with the centrifugal forces. This method of coordination should solve communication and cooperation problems by initiating a permanent process for all actors for agreeing on the aims of performance and production. This discursive coordination should act as a liaison between the requirements of the market and the requirements for cooperation and restructuring inside a company (Tullius, 1999, p. 69).

But there are also tendencies of re-centralization as reactions to problems of decentralization. This refers both to firm organizational aspects, such as the retransfer of once-decentralized company functions back to the headquarters and the reorganization of once-divided firm units into bigger firm units, and to the level of corporate governance, where managers often establish a hierarchic mechanism of coordination (Hirsch-Kreinsen, 1998b, pp. 58-59).

Thus while digital technology makes decentralization and the creation of firm networks even practicable and efficient, it can at the same time be the instrument for re-centralizing certain functions. The implementation of centrally controlled databases and controlling systems leads to a strengthening of central staff and functions. In this regard, the headquarters gain in economic and strategic importance (Tullius, 1999, p. 66).

4. THE CHANGING ORGANIZATION OF PRODUCTION

4.1. Transition to a Flexible Organization of Production

The coincidence and reciprocal reinforcement of intensified global competition and digital technology have created new strategies in the struggle for markets and market shares. Two of these strategies are starting points for a new paradigm of flexibility with far-reaching consequences for the organization of production. Firstly, there is the time-to-market strategy with an enormous reduction in product cycles and market introduction time; secondly, there is the strategy of diversity with a permanent extension of model variety. Both developments place higher demands on innovative capabilities, complexity and variety of components. When isolated, these developments bring more costs. The extension of developmental capacities, the production of increasingly different parts for a broader product range with appropriate investments in tools and machinery, a more frequent modification of assembly lines, higher maintenance and logistic requirements are only a few cost-driving factors. Since the mid-1990s, large corporations, especially in the car industry, have responded with strategies of platforms, common parts and modularization, in order to counteract the effects of cost increases and increasing variety of parts. The strategy of common parts means that economies of scale effects can be attained and the increasing complexity of products and production can be limited (AP – Automobil-Produktion [AP], 2001a, pp. 24-32). The modular strategy also limits the growth of complexity in assembly. It also has the advantage that the accelerated innovation cycle does not require a permanent adaptation of product configuration. Modules with improved technology and quality can be interchanged and used for different product variations, comparable with a building-block system.

However, there are radical changes and new trends in the organization of production. Some of these trends have already been feasible for some time and are undergoing continuing development; for example, outsourcing. Other trends have just started; for example, contract manufacturing as a new form of outsourcing. These developments are particularly important for the most important industry in Germany – the automotive industry. Its structure, and especially that of the supply industry, has undergone dramatic change and will continue to do so in the future. Not only will the relations between the final producers, the original equipment manufacturers (OEM), and their suppliers change, but also the structure of the supply industry itself.

The source of this new production model, contract manufacturing or turnkey manufacturing, can be found in the southern United States, where IBM has farmed out its personal computer production to a subcontractor, but also in Silicon Valley with its information and communications industries (Lüthje, 2001a, p. 86; 2001b). During the 1990s, under considerable pressure due to accelerated time-to-market strategies and high-volume production, the information and communications industries farmed out their production and transferred it to “no-name” contract manufacturers. The companies could not and did not want to finance big production capacities in advance. Only product development and the prototypical production line for starting test runs of new products remained in-house (Naschold et al., 1999, p. 6; Sturgeon, 2000, pp. 67-68; Lüthje, 2001a, pp. 87-89). The essential feature of contract manufacturing (CM), particularly regarding the electronics branch of industry, electronic manufacturing services (EMS), is that the complete chain of production, for example, personal computers, network applications and server, have been taken over by specialized contract manufacturers including production near-engineering and maintenance services. This new form of outsourcing means the production of the entire product outside the company. With a growth rate of 25% per year, contract manufacturing is the fastest-growing segment of the IT sector (Lüthje, 2001a, pp. 86-87). This development is not limited to North America; recently, large turnkey manufacturers began to expand their activities to Europe as well. One of the biggest turnkey manufacturing companies, Flextronics, took over the entire mobile phone production of the Swedish mobile phone producer Ericsson, which no longer manufactures mobile phones in house (Euler et al, 2001, p. 182). The German electronics company Siemens sold its Siemens-Fujitsu factory in Paderborn to Flextronics, which uses it as a contract manufacturer for assembling high-performance computers. Overall, Siemens farmed out a production volume of 33 million mobile phones to Flextronics. It should be noted that not only global players see contract manufacturing as a new business field; recently, a middle-sized German firm bought a telephone plant from Siemens. But global players use the purchase of factories in high-tech, high-wage Germany as competence centers and market entry points for setting up new production sites in eastern Europe. Meanwhile, Flextronics runs several factories in Hungary and its competitor Selectron, the world's biggest turnkey manufacturer, operates factories in Romania and the Ukraine. For contract manufacturers the labor costs are decisive, because 80% of the overall costs are relatively fixed costs. In Hungary a worker earns 2 dollars per hour, in Romania 1 dollar, and in the Ukraine only 30 to 40 cents. Some 70,000 employees worldwide, 26,000 of them in Europe, work for Flextronics. At the moment, the Singaporean company plans to begin the production of base stations for UMTS mobile communication systems (Euler et al., 2001, p. 183).

Another economical advantage that turnkey manufacturers have over brand companies is the capacity utilization of their production sites, because they are able to produce for several different customers. Additionally, they are specialized in manufacturing and have set up appropriately flexible and optimized structures of production and logistics. They employ a high number of temporary workers in order to adapt flexibly to fluctuations in production. In 1997, at Selectron, the world's biggest contract manufacturing company, more than 40% of the employees came from temporary employment agencies (Lüthje, 2001a, p. 91).

For Germany, it is particularly interesting whether this model of production will be applied in the automotive sector, the country's most important industrial branch. Similar developments are indeed feasible. The most radical view of development for the first decade of the third millennium is proffered in a study by PriceWaterhouseCoopers (PWC). They estimate an accumulated overcapacity worldwide of 24 million annually. This translates into 96 of 573 assembly plants worldwide, whose average capacity utilization is currently 69% (cf. Köppen, 1999, p. 87). PWC believes this asset-intensive approach will no longer work in the future. Consequently, they envision a completely new industrial structure, the effect of which will be comparable to the introduction of the assembly line system by Henry Ford in 1913 (AP, 2000b, p. 68). PWC sees the final stage of this development in the shift from the OEMs to the vehicle brand owners (VBOs). Meanwhile, large parts of product development, the entire manufacturing chain, marketing and services will be transferred to new dynamic supplier networks. Branding and customer relations will become the focus of the VBO business. In the process, the concentration of the supply industry will further increase to the point where only twenty to thirty system suppliers might control the market in 2010. With added know-how, the system suppliers could also take over tasks of integration and coordination and sequential tasks (ibid.). Such a development would inevitably raise the question of power structures within the industrial branch. Power would flow to system suppliers, who would control high technology, the "software" and "operating systems" for the "hardware" car body.

Experts and managers agree that the trend toward more outsourcing will endure, and the value-added proportion for the final producers will continue to decrease. This will lead to a gradual structural change in the supply industry. But there are differing estimations of the speed and extent of this development. Differentiated development is foreseeable with already existing plants and volume producers on the one hand and new production sites and niche-car production on the other.

According to Thomas Freudenstein, CIO of the Innomotive Corporation, we will see both outsourcing and contract manufacturing in the niche-car segment, while there will be no radical change in the volume segment concerning outsourcing strategies (Freudenberg, 2000, pp. 76-82). In order to gain possible developmental perspectives, it is helpful to consider the driving and constraining forces of outsourcing. As has already happened in the high-tech industrial branch, the product cycle will significantly shorten in the automotive industry as well. The coverage of all market segments, the variety of versions and the increasingly important proportion of niche cars confront the companies with enormous requirements in terms of flexibility, capital and innovation. Accordingly, the motives for outsourcing logistical and manufacturing processes are mainly production related. Investment risk, capital investments in stock, warranty claims and complexity management should be transferred to the suppliers (Stockmar, 2001, p. 4; Hirschbach & König, 2000, p. 48). Besides the strategies of outsourcing completely integrated spatial and functional systems or intelligent major modules, build-operate-transfer (BOT) strategies will be pursued. Build-operate-transfer models entail the assignment of financing, realization of investment, maintenance, logistics and operations to specialized firms, which are usually part of the supply industry. Yet there are minor differences in the application of these models. For example, the MCC-Smart plant in Hambach, France, and the VW truck plant in Resende, Brazil, are fully build-operate-transfer models. This will also be the case with the new Ford plant in the state of Bahia in Brazil. Although these are only three of 270 assembly plants worldwide, this small number should not obscure the direction of development. Meanwhile, there are many partial build-operate-transfer models, ranging from financing to the operation of complete paint shops and bodymaking (Hirschbach & König, 2000, p. 48). The Dürr Corporation, specialized in constructing paint shops, has purchased the world's largest paint service specialist, the American corporation Manufacturing Support Services, the engineering company Schenck, which specializes in test and automation systems, and Alstom Automotive and Painting Systems, which is active in final assembly. With these acquisitions, Dürr Corporation is able to cover the entire range from a partial build-operate-transfer model to a turnkey manufacturer (AP, 2000c, p. 57). The Austrian-Canadian corporation Magna Steyr[2] has been active in final assembly for a considerable time. It offers the OEMs comprehensive services running the gamut from development to final assembly. In 2000, Magna Steyr produced 86,000 vehicles, mainly for the lower volume segment of niche cars and exclusively for DaimlerChrysler. Magna Steyr took over not only the production of the four-wheel Mercedes E-Class version but also the development of it. Magna Steyr is still expanding in the field of contract manufacturing. From 2003 on, they will be manufacturing a convertible for Saab. Additionally, they are negotiating with BMW, Audi and Porsche to build several niche cars on order (AP, 2001b, p. 76).

There are, however, a number of stumbling blocks on the way to outsourcing:

(1) structures of production established over decades;

(2) different product features;

(3) countervailing power of trade unions.

The automotive industry comprises companies of the old economy with structures established over decades, whose restructuring would require high financial expenditure and likely lead to loss of jobs. In addition, the product feature is substantially different from that of the information and communication or textile industries. A car is highly complex and even minor defects can lead to injury or death. This, in turn, can result in legal problems in the form of warranty and compensation claims. Another important difference from the situation in the United States is the role and strength of German trade unions. The companies of the U.S. InfoCom industry could act exclusively in their interests because the employees were not organized in any trade union. The weakness of trade unions in the new economy is not only the result of the decades-long anti-trade union strategy of electronics companies' management, but also because of the trade unions' reservations against the high number of immigrants employed in this industrial sector (Lüthje, 2001a, pp. 94-98; 2001b). In German industry, especially in the automotive and engineering industries, the potential of trade unions' countervailing power is noticeably different owing to the high degree of organization among employees. Accordingly, trade unions and work councils exercise decisive influence on the extent of outsourcing efforts. For all these reasons, we will not see a simple transfer of the Anglo-American model of production, which is found mainly in the high-tech sector, to Germany.

4.2. Digital Technology: The Driving Force

Digital technology is the pivotal technology and the driving force behind the process of internal and intercompany structural change, particularly the organization of production and product development. But also the relations with the end customer have experienced a radical change. What are the advantages of digital technology applications such as the Internet and intranet? Three main advantages can be named: (a) increases in sales, (b) increases in effectiveness and (c) cost reductions. Accordingly, digital technology raises international competition to a higher level. Companies that miss the digital "connection" risk a decline in international competition.

Table 1: Management methods and corporate objectives in the age of digital technology

Branch	*Digital applications*	*Management method*	*Company objectives*
Product development	CAD/Cax-engineering program; vision: Internet-based engineering on Internet platforms	Simultaneous engineering; cross-functional development	Product cycle/time to market acceleration; product diversity
Procurement	Digital platforms: business to business (B2B)/Internet marketplaces	Supply Chain Management; bidding procedure/auctions	Supplier/logistic integration; process acceleration/ optimization; favorable procurement
Quality management	Intranet	Business/performance excellence	Process-oriented quality control/ optimization
Customer-relations	Digital platforms: business to customer (B2C); customer to business (C2B)	Customer relationship management	Set up of long-term customer relations; customer satisfaction
Internal processes	Intranet	Process-oriented managing; employee services	Internal process optimization/accelerat ion; people empowerment
Intercompany processes	Internet	Supply chain management; vision: value chain management; business intelligence solution	Process optimization of parts of value-added chain; vision: full integration of entire value-added chain into one IT system
Source: own composition			

Table 1. gives an overview of how companies apply digital technologies, in which sectors, with which innovative solutions and with which objectives. There are many interfaces and interface problems between the sectors and the applications. One main objective of future innovation will be the development of a single system that is able to integrate all sectors. Under the name of value chain management (VCM), software developers will compete to find practicable system solutions for developing the market of the future (Schubert & Reppesgaard, 2001).

While in the past it was mainly the big companies of the new economy that employed digital technologies, today we see increasing implementation of these technologies in the so-called "old economy". For example, the Gartner study, an analysis for the network company Cisco Systems, predicts that Internet business turnover of currently 26 billion U.S. dollars will increase to 340 billion U.S. dollars in 2004. The main players in this development will be the international operating companies of the old economy, which will utilize these Internet-based business models as quickly as possible (Zapp, 2001). Even if this growth rate is exaggerated owing to the current consolidation of the IT sector and the fact that the extent of new trends is often overestimated, the study shows the direction of development. Putz & Partner surveyed 348 companies and came to the conclusion that in a few years there will be no difference between the new and the old economy or between business and electronic business, but e-business will be an integral part of the future economy. The companies surveyed predicted that the Internet as a contributor will raise its share from 17% of turnover at the end of 2000 to about 30% in 2003. 50% of the firms interviewed plan or have already established business to business (B2B) contacts to their business partners. 24% are involved in digital marketplaces (Richter, 2001). This important development is also seen at management level, where more and more IT managers with a business background are finding positions ("Balance zwischen", 2001). Many companies, however, make stipulations for investments in e-business, investing only in those e-business solutions capable of reducing costs, provided that costs are kept strictly under control and success and return on investment are guaranteed. Investments were made primarily in business to business, customer relationship management and e-collaboration (Schnabel, 2001).

The main trend of e-business is toward setting up networks between different companies, particularly in the electronics and automotive sectors and in sectors with a high degree of customer-supplier relations and outsourcing. This collaborative strategy of networking allows the final producers to concentrate on core competencies and to manage logistics, transport and the supply chain from the first-tier supplier to the n-tier supplier.[3] The IT-supported system of supply chain management enhances flexibility and effectiveness between the business partners. Better coordination, synchronization and optimization of processes can reduce storage costs, material waste and transport costs. Electronic trade and marketplaces and Internet-based platforms form the infrastructure for the processes mentioned above (Schnabel, 2001). Internet marketplaces, if optimally developed, should usually fulfill three functions: a) purchasing, b) logistics and c) engineering (Eichler, 2001, pp. 18-19).

For purchasing, mainly auctions, bidding procedures and catalogue systems are currently being used. The first experiences with auctions in the automotive industry show that savings can be made on the side of purchasers, whereas suppliers come under price pressure. While recently initiating a bidding procedure for cooling water tubes, Ford set the starting price at eight percent lower than the current market price. After half an hour of bidding, Ford granted a further price discount of 20% (AP, 2001c, p. 96; AP, 2001a, p. 28).

Internet-based auctions are only one possible use of Internet platforms. Presently, mainly standardized and less complex supply parts are sold by auctions because more complex parts and modules often require developmental partnership. This means that above all the lower tiers of the supply chain experience the highest pressure of competition.

The proper benefit is the acceleration and optimization of processes along the entire producer chain, from development, procurement of raw material and components, to production and distribution (AP, 2001c, p. 96). A Goldman Sachs study on the U.S. market proceeds on the assumption that there will be potential savings of about 3,500 U.S. dollars per car if e-business is used correctly (Bernhart & Feige, 2000, p. 114-115). Employees will be relieved of standardized procedures and can focus on core tasks. Accordingly, for example, the dispatch of needed information material to the supplier can be reduced from fourteen days to one day (Hofer, 2001). A more skeptical appraisal with regard to savings effects comes from a joint study by the management consulting firm Roland Berger and Deutsche Bank. The study was based on interviews with approximately 150 managers from the automotive industry. They were asked about their expectations with regard to Internet utilization. In their view, the savings for the production of a car in the U.S. with the use of Web electronic data exchange by auction-based procurement averages 400 U.S. dollars due to reduced negotiations and price reductions. A further 800 U.S. dollars in cost reductions can be achieved in the value-added chain downstream to procurement. This cost reduction would be the equivalent of 4.9% of an average car price of 25,000 U.S. dollars ("Automobilindustrie beurteilt", 2001; AP, 2001c, p. 96). The European automotive industry, because of different production and distribution conditions, will not be able to achieve such a high level of savings. Some authors estimate about 1,000 U.S. dollars per car (AP, 2000d, p. 114). The consultant Roland Berger and Deutsche Bank see a potential cost reduction of about 640. U.S. dollars This would be the equivalent of 3.4% savings based on an average car price of 7,000 U.S. dollars (AP, 2001c, p. 96; Brikè & Sedran, 2001, p. 6).

Engineering via an Internet market platform is still in its infancy or in some respect developed. This field still works in cooperation with special engineering systems at this time.

4.3. Process Orientation instead of Function-Related Management

A decisive trend that digital technology initiated is the replacement of product-oriented manufacturing in production-oriented factories with process-oriented business units with interfunctional responsibility. This development is evident in the corporate organizational structure, which is increasingly divided into interfunctional business units. Function-related management diminishes in importance, while by contrast IT-controlled self-organization increases in importance and leads to the reduction of administration and mid-level management (Neumann, 2000, p. 40). In work organization, entire work processes are reorganized as well. Instead of rationalization of single procedures, a systemic rationalization occurs. The aim of process orientation is to overcome the limits of functional specialization of operational productivity processes. Business reengineering and change management execute the transformation from function-related to process-oriented organization (Bierbaum, 2000, pp. 151-152). We see the same change in quality management. According to Klaus Zink, total quality management has had only limited success because it focuses exclusively on product and production quality, and its application pursues, above all, short-term saving goals. The new process-oriented quality management, called business, organizational or performance excellence, takes a holistic approach and has an enhanced evaluation (Zink, 2000, pp. 24-31). Formerly, quality was improved through avoiding defects in components, and quality management took place only inside the factory. Process-oriented management focuses on the efficiency of every activity along the process chain and intervenes if necessary (Rudnitzki, 2001, p. 12). Complementary to process orientation in production and company organization and quality management, we see the transition from cost center calculations toward process costs calculation in the field of cost management (Neumann, 2000, p. 40). The transition from function-related management to process management will be realized primarily by supply chain management via the Internet and intranet. Supply chain management has however the disadvantage of covering only one part of the value-added chain; planning, development, marketing, distribution and customer services must be controlled by other non-integrated systems. Therefore, software researchers are endeavoring to develop fully integrated system solutions. Value chain management or business intelligence solutions are the visions of the near future. They have the objective of integrating all parts of the value-added chain – planning, development, supply, trade, import, marketing, customers and customer services. This means, in other words, the integration of simultaneous engineering, supply chain management and customer relationship management into one IT system (Neumann, 2000, p. 40; Gilg, 2001).

5. NEW MARKET STRATEGIES IN THE DIGITAL ERA

The integration of supply chain management and customer relationship management into one standardized IT system would greatly accelerate the information flow from the customer via the dealer to the producer and to the supplier. Customer suggestions could be taken up quickly and immediately translated into market action; in this way, it would be possible to improve the time-to-market strategy. Business intelligence solutions are a precondition for future visions of build-to-order and build-on-demand. Automobile producers in particular see this as a strategic task. The customers design their car as they wish and order it. The fully integrated IT system then initiates all necessary processes for production. The aim is to deliver the car to the customer within the shortest amount of time. The target period of time from order to delivery should be about ten working days. In five to ten years, the ten-day car could become a reality (Kaplaner, 2001, p. 6; Hofer, 2001). Besides an integrated information flow, this realization presupposes a highly flexible and fast production system and corresponding work organization. The German dialysis producer and dialysis clinic operator Fresenius Medical Care has already reached this stage of development. They are able to deliver the ordered product within two weeks to customers worldwide (Marsh, 2001, p. 4). Again, the study of Roland

Berger Consulting and the Deutsche Bank arrives at a more skeptical appraisal. They proceed on the assumption that it will remain a dream to order a car as one wishes via the Internet and to pick it up within a few days at the dealer ("Automobilindustrie beurteilt", 2001).

The realization of the build-to-order strategy in the car industry raises a lot of questions. How can it be possible to serve markets within two weeks if there is no production site or one that does not produce the model in demand? An automobile with its special features cannot be economically transported by plane. Producers and dealers in the United States practice a build-to-stock approach, which means cars are produced for the stocks of dealers. In Europe, customers prefer to purchase on order. Accordingly, for Europe a build-on-order strategy is imaginable. But it raises the question what effects the realization would have on industrial structures and work organization. Would the enormous requirements of flexibility and time promote and accelerate an industrial, product-related "cluster forming"? Could the transition toward more flexibility of assembly lines keep pace with the increased general flexibility demands or would it lead to more manual work in the final assembly?

An important strategy is customer relationship management. On an IT-based system, customer behavior and wishes are systematically identified for the purpose of long-term customer relations and customer satisfaction (Gilg, 2001). The ever increasing influence of business-to-customer and customer-to-business systems has had a lasting effect on the organization and strategies of companies, particularly on the automotive industry. For the customer, the Internet creates transparency and facilitates the comparability of products. Strengths and weaknesses are discovered and competition is intensified. The customer also has the possibility of interacting with the final producer, to ask questions or formulate wishes. Decelerations or lacking transparency can be interpreted as incompetence on the part of the final producer and possibly lead to sanctions by the customer and a change of brand. In this context, the service offered will be more and more important for a customer's purchasing decision. In this field, "service providers" have already proliferated, such as CarPoint and CarsDirect, which offer mobility for a fixed price without negotiation stress including financing, insurance, and return guarantee (Neumann, 2000, p. 41). The customer relations for car purchasing occurs prospectively more and more, analogous to computer purchasing, through offers of hardware and software, of car and service. The current trend in the communications sector is to offer the hardware product – for instance, the mobile phone – as a bonus after signing a mobile phone contract. This development will not occur to the same extent in the automotive industry, but in the future automobile and service, especially multimedia systems such as dynamic navigation, voice-controlled Internet and infotainment, will be inseparably linked.

The car will be redefined and the business model, the object of the company, is liable to change. If car producers intend to participate in this profitable part of the value-added chain, they will have to develop their core business toward the service sector. Many car producers have already taken some steps in this direction. They have taken over car rental companies and set up banks, financial and insurance services and thereby extended their business fields. In the near future, they will primarily integrate multimedia technology and services. This will be achieved by acquisitions, cooperations and by starting up new technology and service firms. This business migration will meet competition in the service sector, which is moving in the opposite direction. The strategic consequence of this convergence of competition is the expansion of the final producers' core competencies (Stockmar, 2001, p. 14).

Future visions proceed on the assumption that in the year 2010, automobile producers will have to stop manufacturing and development and focus exclusively on branding and brand identification, on which their success will depend (Stockmar, 2001, p. 14; see also Table 2.).

Table 2: Automotive industry – trends

1980	**2000**	**2010**
OEM	**OEM**	**OEM**
• brand • design • development • tools • development of manufacturing process • manufacturing of parts • car body making • paint shop • rough cut • manufacturing • logistic • procurement • distribution • after sales **supplier**	• brand • design • developmental integration • car body making • paint shop • manufacturing • logistics • procurement • distribution • after sales **supplier**	• brand • design • distribution • services **system integrator** **system and module supplier** **?**
Source: Stockmar 2001; Jürgens, 1999		

In order to stress this development, the management consulting firm PriceWaterhouseCoopers cites successful clothing firms (e.g. Armani) and the luxury food industry (e.g. Procter & Gamble), which do not have any production sites (AP, 2000b, p. 68). The so-called "branding", the reputation of the brand and associations with it are at the center of business activities. The slogan at Volkswagen of America is a case in point: "We do not sell hardware, we give away heartware" (Neumann, 2000, p. 43).

6. REVOLUTION OF THE PRODUCT DEVELOPMENT PROCESS

Product development is a complex process that includes not only designing and developing, but also toolmaking and engineering. It covers the phases of concept development, concept hedging, serial production development and production preparation and integrates a number of specialized functions, organization units and firms. The heightened international competition indicated by market requirements to accelerate product cycles and to increase product variety and variation confronts the developmental departments with major challenges. Innovation and product development are of pivotal importance for the continued existence of companies and are therefore a core competence of business in nearly all branches of industry. This does not mean that there is no change or transfer of competence inside the sector. Despite rationalization and developmental optimization, the personnel stagnating developmental departments are often unable to fulfill the increasing requirements for complexity and innovation because of cost cutting. A necessary extension of capacities has resulted externally by outsourcing development services or by farming out to component or module suppliers or to engineering firms. This leads to a comparably more frequent network forming than in the manufacturing sector. In the automotive industry we see exemplary developments. The shortening time strategy for product development focuses, above all, on the interval between the decision for serial development and the start-up phase. At the beginning of the 1980s, European car producers needed about fifty-seven months for this period. At the end of the 1990s, it was about thirty months. This period includes many different tasks, including design activities, platform development, component and module planning and production preparation including planning of procurement. The number of different participants and interfaces results in interface problems. In an endeavor to solve communication and cooperation problems during the 1990s, many automobile companies established integrated development centers, and many suppliers set up development offices in this environment. As early as 1987, BMW set up an integrated development center and a few years later Daimler-Chrysler set up a technology center, which will have 10,000 employees in the future, while the system integrator Magna opened a development office near the VW headquarter in Wolfsburg, Germany (Jürgens, 1999, pp. 163-175).

While processes were primarily sequentially structured in the past, today the development centers organize processes in an increasingly parallel and cross-functional manner. Simultaneous engineering is the pivotal innovation of the development process, which is characterized by integration, process orientation and cross-functionality. Digital networks are the key to successful and efficient simultaneous engineering. They enable a comprehensive integration and an accelerated exchange of data between all partners in the development process. Suppliers, designers, suppliers of raw material, all organization units can be involved early on and parallel to the developmental process. This reduces the time needed for development and innovations.

The systemic concept for product design – platform, common parts and modular strategy – reduces additionally the expenditure for development and costs of production (Naschold et al., 1999, p. 9; AP, 2000a, pp. 44-46).

Table 3: E-engineering: new chances through e-business

effects through e-business	***results***	***chances***
increase of data trans-parency	• avoidance of redundant developments • reduction of changes • increase of COP proportion	reduction of development cost (7-10%)
increase of data integrity	• reduction of rework • increase of market fit	
increase of process transparency	• higher transparency of development processes for decision-makers • increase of cost transparency of entire supply chain	reduction of processing time(20-30%)
focus on value-added activities	• reduction of administrative development activities • possibility of 24/7 development through global developmental teams	improved product quality
Source: Brikè & Sedran, 2001		

The application of digital communication technology and computer-based engineering in the product development process has prompted the discussion of geographic separation of development activities and has questioned the purpose of centralized development centers (Jürgens, 1999, pp. 175-176). The set up of engineering tools as a part of Internet platforms sustains the trend toward geographically separated product development. Crucial to the successful realization of simultaneous engineering concepts and the reduction of interface problems is the introduction of project organization, also called team empowerment. Project teams work as relatively independent groups and are responsible for implementing projects (Naschold et al., 1999, p. 9). In this case, the cross-functionality of composition is of vital importance. By integrating the person responsible for procurement, shell construction, design and assembly, who themselves lead specialized teams, it is possible to have a precocious coordination and realization of the emerging product with the procurement strategy and the assembly lines (AP, 2000a, pp. 44-46). It is also possible to send resident engineers to partner firms in order to accompany the processes of development and innovation for a longer period (Naschold et al., 1999, p. 9; AP, 2001a, p. 28).

7. CONCLUSION

German industry finds itself at a crossroads that will have a critical impact on the characteristics of the German Model. The restructuring process is dominated by the export-oriented branches (i.e. the automotive, chemical and mechanical engineering industries) and is characterized by a shift in focus from stakeholder to shareholder value. Both features are a reflection of holding to German mercantilism under the changing conditions of global competition. The main trends of industrial restructuring can be summed up as follows:

(1) Vertical disintegration and network building;

(2) outsourcing and contract manufacturing;

(3) flexibilization of production organization;

(4) acceleration of product cycles and innovation;

(5) shareholder value-oriented corporate governance;

(6) company internal market relations as a new method of company control;

(7) acceleration and control of all processes by digital technologies.

These restructuring processes, fueled by globalization with its increasing cross-national mobility, a predominance of shareholder value practices and heightened international competition, have changed the relations between core firms and their suppliers and shifted the balance of power between capital and labor to the benefit of capital.

Firstly, the more complex a product, the more eager the relations between core firms and suppliers and the stronger the interdependence. The relations are based more on confidence and reliability than on constraints by competition. Because of their continuing market power, the core firms still dominate the relations, but it is harder to control the profit allocation of the value-added chain under these new conditions.

Another result of vertical disintegration, outsourcing and production flexibility is an increase in the wage structure segmentation and in unstable and precarious employment due to temporary work. Additionally, pressure mounts on German occupational education and its duration (three to four years) because firms want to integrate young people faster into productive work and place them more flexibly. For both firms and career-starters, long and specialized occupational education is not always needed. One example for this trend is the new productive model of the Volkswagen enterprise – the Auto 5000 company – which has introduced a six-month on-the-job training to qualify future car manufacturers.

Secondly, trade unions, collective bargaining autonomy and codetermination at plant level are facing big challenges. The main trends of industrial restructuring put strains on traditional labor relations and force all actors, particularly trade unions and works councils, to adapt to the new conditions. Disintegrated and increasingly branched companies undermine the current works council structures and weaken their position. Additionally, codetermination and collective bargaining agreements come under the pressure for change due to the increasing cross-national mobility of capital and shareholder value management strategies. The works councils of the big companies have already overhauled their policies since the late 1980s while undergoing a change in self-conception, from that of a pure protector of workers' rights to a formative corporate power. Management has also involved them in the recent restructuring process. The new works councils' philosophy is not unproblematic because many employees now see them as co-managers and hold them responsible for flexibilization, deteriorating working conditions and higher work pressure. The trade unions often meet the pressure for change with special sectoral bargaining contracts and the possibility of opening clauses on companies' level. This strengthens the power of the works councils over the trade unions relative to collective bargaining policy and negotiations of working conditions. In industrial sectors or companies where the trade unions are still powerful and well organized, their influence on management decisions and corporate strategies as well as the protection of workers' rights will continue to be notable, although the pressure of global competition restricts their scope of action. But in sectors or companies with a low degree of organized trade unionists and a consequently weaker works council, the pressure on wages and working conditions will increase and the downsizing process will continue and possibly accelerate. As a result, the divergence of wages and working conditions will be larger, and more and more employees will be shut out from the achievements of the trade unions, thereby increasing the heterogeneity and segmentation of the working class.

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NOTES

[1] Wintelism: Acronym for the standard-setting technology of the operating system producer Microsoft with its operating system Windows and the dominance of the component and chip producer Intel.

[2] The original Austrian company Steyr-Daimler-Puch was taken over by the Canadian company Magna International and their vehicle branches were merged and restructured. Magna Steyr is one of the largest system and module supplier of the automotive industry. Magna Steyr employs 15,400 people, 6,300 of them in Austria. Magna International itself is a holding company with 58,000 employees and 177 production sites.

[3] n-tier: "n" is a quantitative characteristic and means in this case the last tier in the supply chain.

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Chapter 5

MICHAEL FICHTER

THE GERMAN WAY

Still Treading the Path of Institutionalized Labor Relations?

1. INTRODUCTION

The mercurial growth of the New Economy in Germany at the end of the 1990s set off much speculation about whether this was the beginning of the end of the German system of labor relations. The booming New Economy seemed to herald a dynamic shift from the industrial sector to the (tertiary) services sector, fueling both the fears of the unions and the hopes of neoliberals that the end of the *Deutschland AG* (Hank, 2000), the corporatist system of inclusive interest negotiation, was close at hand. While the unions scrambled to establish a foothold of representation[1] in a sector where management-controlled employee relations rather than negotiated collective labor relations are the rule (Schmierl, 2001; Ittermann & Abel, 2002), Hans-Olaf Henkel, the voice of the German Confederation of Industry at the time, was motivated to announce with his typical self-assuredness that "nobody wants our model anymore" (Henkel, 1997).

The collapse of the New Economy boom in 2002 halted much of the speculation regarding the sector's immediate impact on further economic restructuring and on the resulting effects such changes would have on the complex and highly regulated system of labor relations in Germany. But that by no means signaled a return to the normalcy of a stable and institutionalized system of interaction between the organized interests of capital and labor that the label "German Model of labor relations" had come to suggest earlier. Indeed, the difficulties that the collective regulation of employment relations faced in the New Economy were generally symptomatic of the problems that have affected the German Model increasingly since the 1980s. Indeed, recent conflicts such as the strike debacle suffered by the IG Metall in eastern Germany (2003) and the subsequent employer offensive for longer hours of work seem to have exacerbated the situation. Both actors' choices and long-term socioeconomic structural changes are forcing adjustments to the system, increasing its existing diversity and reshaping its functionality.

This paper will explore the state of affairs and reflect on the restructuring of the German Model of labor relations under the impact of national, European and

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international changes. What are the major political and economic factors affecting labor relations in Germany and how are they influencing the system? Who are the important organizational actors, what are their foremost problems, and how are they reacting strategically? Finally, what kinds of changes may be evolving, and what are the prospects for their negotiated settlement?

I will argue that economic regionalization (in an expanding European Union) and globalization are undermining the institutional foundations of the German system of labor relations and causing the actors to redefine their organizational positions and their strategic choices. While institutional resiliency is still prevalent, offering a still widely accepted referential base for the actors involved, the system of labor relations is facing increasing pressure to devolve collective regulation to the enterprise or plant level, thus embarking on a transformation process with far-reaching organizational and strategic ramifications for the established procedures and power relationships within the national context. Political deregulation and technological advances have stimulated a dynamic growth of opportunities for cross-border expansion of even smaller firms. With the deregulation of the labor market, pressures from labor migration and foreign competition, and the dismantling of the Fordist welfare state, a new relationship is in the making between nationally oriented and anchored trade unions and internationally operating business interests. Consequentially, both the interaction of the "social partners" with each other and with government, and the institutional context in which this occurs are marked by the introduction of new – both proactive and reactive – and, in part, contradictory strategic interests. In the ensuing centrifugal-centripetal "push-pull" struggle, the historically embedded balance of power – an asymmetrical partnership – is being reframed with far-reaching consequences for the organizations and representatives involved as well as for the system as a whole. The "German Model" of labor relations as a particular national construct is undergoing a permutation, the outcome of which will depend not only on global political and economic structural change, but also on the strategic choices and opportunities pursued by unions, employers and government in Germany.

After an introductory review of the German Model of labor relations and its characteristics in the context of its historical development, the paper will discuss the controversial issue of the "erosion" of the model (Artus, 2001; Hassel, 1999; Hoffmann et al., 1998). This will lay the groundwork for a presentation of the major national, European and international developments affecting the model. With these trends in mind, I will then turn to the actual problems and issues of conflict such as membership decline in the unions and the employers' associations, the extent and depth of decentralization in collective bargaining, the problems of neo-corporatist social pact policy, and the political controversies surrounding demands for a reform of the system. In conclusion, I will sketch out possible trajectories of change in the near future. Are labor relations the Achilles' heel of stability, growth and competitiveness as Germany confronts the demands of a globalizing environment? What future is there for trade unions? Will they degenerate into mere "transmission belts of transnational competition" (Altvater & Mahnkopf, 1995, p. 101), or can they actively be involved in and influence the shape of industrial relations and the goal of economic democracy in the years to come? And what is the future of employers' associations? Will they end up – actively or passively – dissolving themselves, as some of them have threatened to do?

2. THE DEVELOPMENT OF THE GERMAN MODEL OF LABOR RELATIONS

The success of the West German economy in overcoming the devastation of World War II may certainly be attributed to a favorable international political and economic setting. As the rift between the Western allies and the Soviet Union grew, West Germany was drawn into the American camp to contribute to the anticommunist effort and present a showcase of affluence and success. In principal, the consolidation of a stable political democracy and the building of a powerful export economy based on the concept of the social market economy (*soziale Marktwirtschaft*) proved to be a most solid foundation in fulfilling this role (Smyser, 1993).

One of its key elements has been a reliable and functional system of representation by the organized interests of labor and capital. The rebirth of trade unions after 1945 was geared to creating a participatory role for labor in securing economic and political democracy. For their part, the employers labored under the legacy of the responsibility of German capital for the debacle of Nazism and war. To counter labor's bid for a potentially dominating role, they offered extended recognition and a share of responsibility and decision-making power. Thus the constraints of historical legacy on the employers' side and the desire for participation on the unions' side intertwined to produce a "reconstruction pact" (Niethammer, 1978), a historical compromise of mutually accepted and beneficial arrangements. This high level of political recognition was institutionalized and consolidated during the first three decades of the West German state. Its main institutional and organizational elements are:

The German constitution (Basic Law, Art. 9.3): A guarantee of the right to "form associations to safeguard and improve working and economic conditions", from which the Tarifautonomie, that is the right of trade unions and employers (or their associations) to regulate working conditions without state interference, is derived. This means, too, that there is no minimum wage[2] and no compulsory arbitration by the state.

Sectoral contract agreement (Flächentarifvertrag): Contract bargaining is overwhelmingly at the sectoral level between trade unions –almost exclusively the member unions of the Deutscher Gewerkschaftsbund (DGB) – and employers' associations. By law (Tarifvertragsgesetz 1949), only unions may sign collective agreements on behalf of employees, while individual employers may bargain with the union on their own. While the collective agreement legally applies only to union members employed in companies that are members of the employers' association or have their own "in-house" union contract, employers generally extend contract provisions to nonunion employees as well. As such, the rate of coverage (sectoral and individual enterprise contracts) for all employees is rather high. In 2001, it was 71% in western Germany and 56% in eastern Germany (Institut für Arbeitsmarkt- und Berufsforschung [IAB], 2002). The sectoral contract agreement ensures industrial peace for the life of the contract. Its existence enables interest aggregation at a relatively high level on both sides of the negotiating table, setting standards of performance primarily within, but also across, recognizable sectoral boundaries.

Industrial unionism: The dominant union organizational form in Germany is representative trade unions with branch-wide (and multi-branch) jurisdiction according to the principle of "one workplace – one union".[3] Their counterparts are representative employers' associations. Each side has a mandate of its members to negotiate employment contracts at the sectoral level independent of state interference. Moreover, unions and employers' associations are also an integral element of the regulatory agencies of labor market and social policy, to mention only their most prominent areas of participation in a wide range of state agencies and semi-official bodies.[4]

Works councils: Parallel to the highly visible role of employers' associations and trade unions, there are organizationally separate and legally institutionalized enterprise-level organs of employee representation, that is the works councils (*Betriebsräte;* in public service: *Personalräte*) and codetermination at the company board level. Mandated by law to represent the entire workforce within its jurisdiction, works councils are not just the "extended arm of the union". Works councils have responsibilities and commitments that both tie them to the enterprise and give them a degree of independence from union influence (Fichter, 1988). And yet, in times of conflict, the assurance of union support can provide the bargaining leverage they often lack on their own. This dual, or complementary, instrument of employee representation – trade unions for collective bargaining and works councils for workplace issues – has fostered conflict resolution and flexible adaptability to technological changes. It has also made a significant contribution to stabilizing interest aggregation and decision-making processes within the unions (Streeck, 1979). The integrative and consensus-building function of codetermination has been especially singled out as being largely responsible for the admirably high level of labor peace and for contributing to union moderation in wage bargaining.

Extensive judicial framework: A further essential element of this system of labor relations is a framework of legal regulations for dealing with labor disputes that the affected parties have not resolved on their own. Measures that remove potentially bitter labor and employment disputes from the workplace range from mediation and arbitration to a network of labor courts, whose professional judges are assisted by equal numbers of lay judges nominated by employers' associations and trade unions.

Vocational training: Parallel to the "academic track" of schooling (*Abitur*), the German educational system in cooperation with business provides job qualification through apprenticeships based on classroom attendance and practical training courses within the enterprise. On a second tier, institutions of more specialized qualification, such as vocational colleges (*Fachhochschulen*), serve to train for higher-level job opportunities. The system ensures the availability of a highly skilled and, in regard to job content, mobile workforce able to contribute to product quality and innovation as well as to production efficiency.[5]

Social welfare state: The enveloping framework for these elements is a social welfare state with recognized and effective boundaries and explicitly neo-corporatist arrangements at the national, regional and sectoral levels.

The participatory, regulatory, and negotiated settlement culture of these institutions and organized interests developed and thrived in the post-war Keynesian world of economic policy. The label *Modell Deutschland* – or German Model – which appeared in the social science literature in the 1980s (Dufour, 1998; Müller-Jentsch, 1995), epitomized the neo-corporatist theorem for explaining economic adjustment and crisis management (Schmitter, 1981; Cameron, 1984). Despite recurring class conflicts as well as disputes over the regulations of the balance of power, there was an overriding understanding that interest articulation on the part of one side or the other should not escalate and rupture the high level of consensus that had been attained. Moreover, this was possible not in the least because the boundaries of the model's application – the West German state and its *soziale Marktwirtschaft* – were clearly defined and accepted.

The academic literature of that period generally reflected the summation which Peter Katzenstein made at the end of his edited volume, *Industry and Politics in West Germany*, that "short of unforeseeable major upheavals [!], pervasive small-scale change and experimentation in industry is compatible with a large measure of stability in national institutions and politics without sacrificing West Germany's international competitiveness." (Katzenstein, 1989, p. 353) Nevertheless, the model began to draw criticism as the decade of the 1980s came to a close because it was not always functioning according to the high expectations with which it had been associated (Hohn, 1988; Streeck, 1996). The most glaring problem was (and still is) clearly unemployment, flanked by structural changes in the labor force (i.e. increasing number of women), company restructuring, the reorganization of work, and labor-reducing technological innovations. But still, most observers agreed that the German Model with its dual system of interest representation (trade unions-employers' associations; works councils-enterprise management) was well equipped to handle such adjustments (Turner, 1991) and did not regard them as harbingers of fundamental difficulties ahead. Since then, of course, Katzenstein's "unforeseeable major upheavals" have become reality:

(1) The growth and spread of international enterprises with a transnational perspective for flexible production, the utilization of labor, marketing and financial transactions. This "globalization" seriously challenges the functionality and existence of the national system of labor relations and labor regulation in Germany, not in the least by "global sourcing" (Hoffmann, 1997, p. 86) and fostering deregulation, social dumping and "regime shopping".

(2) The incorporation of the former German Democratic Republic (GDR) into the Federal Republic of Germany (FRG) in 1990. Economic transformation and cultural and political integration is still a demanding and costly task today. As one analysis of labor relations in eastern Germany concluded, the institutional setting transferred from West Germany "proved to be a formally functional, shock-absorbing

system of regulation, but only minimally adaptive to handling new problems" (Ettl & Wiesenthal, 1994, p. 447).

(3) The dissolution of the Soviet bloc has also opened up a staging area in the countries east of Germany begging for dynamic market utilization. These countries are growing in importance as investment recipients, trading partners, and providers of qualified and low cost labor. After accession to the EU, these countries will continue to provide German firms with opportunities for relocating production (cf. Dörrenbächer et al., 2000; Gradev, 2001), and they may even host an even greater inflow of capital and goods from the rest of the EU.

(4) The process of European integration, especially since the agreement on the Maastricht Treaty (1992/1993), has profoundly influenced the internal workings of the model by redefining and even removing regulatory elements from the German Model. Here, too, low-cost labor has become readily accessible to capital through the recognized principle of the free flow of goods and persons within the EU. With the introduction of the Euro as the common European currency, the mobility of capital has been enhanced even further.

For the past few years, the buzz word "erosion" has generally guided the academic discussion of the impact of these and other factors on the German Model of labor relations. It is certainly not irrelevant to analyze the disruptive and even destructive effects of dynamic processes of change in both national and international constellations of the political economy. This is crucial for our understanding of the parameters of political action and strategy development in regard to the challenges faced by the organizational actors in the field of labor relations. But it is only a starting point from which we should proceed to the question of the policies, strategic choices, and development trajectories to be considered as institutional power relationships are adjusted in the context of new demands and needs. Pointing to "erosion" without considering the proactive and reactive capacities of the actors involved is a teleological dead end in which the outcome, the ultimate demise of the German Model, is seemingly unavoidable.

3. COMPETITIVENESS AND SOLIDARITY: LABOR RELATIONS IN A CROSSFIRE

The essence of my argument is that the German Model of the 1970s was already beset with problems by the 1980s, but these were held in check by a powerful and stable institutional environment. However, unemployment was already menacingly large, and once the Wall fell, the Soviet bloc imploded, the German unification process began, and the EU Single Market reached completion, the existing economic changes brought on by technological development and market restructuring were noticeably exacerbated. A level of reciprocal, split-pattern interlocking and fluid relationships among national, European and global factors is emerging that questions the future viability of sustaining a comprehensive and distinctively national pattern of labor relations, even in a more deregulated and decentralized version.

Looking at the conflicts over reforms that have surfaced most recently, at the debates over the efficacy of the institutions and instruments of the model, and considering the "normal" union-employer bargaining over substantive issues as well, there emerges a mixed picture of strategic and tactical moves. To illustrate this, the following section will review developments and problems in three key areas of the German Model: The sectoral contract bargaining arena, the arena of enterprise-level bargaining, and trade unions and employers' associations as representative membership organizations.

3.1. The Instrument of Collective Bargaining: Der Flächentarifvertrag

The sectoral collective agreement is the key instrument of systemic regulation,[6] setting minimum wage standards – generally oriented on productivity and inflation – and defining the boundaries and content of company-level bargaining over issues of work organization. It is this instrument – along with its pattern bargaining effects – that has been targeted by employers and conservative/neoliberal politicians for elimination (Fichter, 2003). In some sectors, such as engineering and auto production, the union (IG Metall) and its opposite on the employers' side (Gesamtmetall) wage public battles over the reform of the *Flächentarifvertrag*, mirroring their often acrimonious bargaining rounds. In this sector, the process of reform began as early as 1984 with a compromise in which the union accepted more company-level flexibility and regulating freedom in scheduling work-time in exchange for employer agreement on a general shortening of working hours (Bahnmüller & Bispinck, 1995, p. 145).

In contrast, the mining and chemical workers' union (IG Bergbau-Chemie-Energie [IG BCE]) goes on record in defense of the level of "social partnership" it has achieved with its counterpart employers' association. Both organizations have publicly criticized the way in which the problems of the metalworking industry have distorted the discussion of the collective bargaining system in general (Terbrack 1995, p. 30; Jacoby & Behrens, 2001).

Up to the end of the 1980s, employers generally ignored calls from politicians to do away with the sectoral contract or to turn it into a mere framework agreement. Today, this support is no longer certain, although a general acceptance of its advantages (Thelen & Wijnbergen, 2003) is still discernable (Sievers, 2004). Employers argue that the German system as a whole is too regulated, inflexible and cumbersome to function effectively in today's globalized economy, pointing specifically to the fact that the sectoral collective agreement fails to reflect the liberalization (deregulation) of economic structures in Europe and indeed throughout the world. While the system is designed to take wages out of competition, ensure labor peace, and create upward pressure on firms to develop technologically high standards using highly skilled and well-paid employees, its protective mechanism is increasingly vulnerable. For one, it is embedded in a macroeconomic context, which is continually being challenged by the microeconomic, profitability arguments from a single firm perspective. Secondly, the sectoral contract is a regional and national instrument. Wage competition may be eliminated within the jurisdictional limits of the contract. But when these limits do not coincide with market structures, and when there is no protection against outsiders entering the market and undermining the German standards, the sectoral agreement's claim to be a protective instrument becomes a farce. In the end, it makes no difference whether these "intruders" are foreign enterprises, or German-owned firms that are not members in an employers' association, or whether they are foreign or German workers ready to offer their skills at a lower price. When such an instrument loses its ability to control, it leads to the building of coalitions that bypass its regulating capacity in search of new means of regulation. In Streeck's terms, we find "coalitions between employers, who want to lower their wage and possibly their training costs, and employees, who prefer lower pay to no pay at all." (Streeck, 1996, p. 91) Especially in eastern Germany, illegal "flights from the contract" seem to be silently acknowledged by the employers' association as a means of avoiding a "flight from membership" (Schroeder & Ruppert, 1996, p. 41). At the same time, undercutting a valid contract is only feasible when employees have no union or works council representation, or when these acquiesce to such a scheme. Under the conditions of jobless growth and less secure employment, works councils are under pressure to assent to these and other cuts.

Union reform proposals for the sectoral contract are based on allowing more enterprise-level bargaining while maintaining union control over the process. The basic position of the DGB unions is reflected in a policy statement recognizing the need for a new relationship between sectoral contracts and their shop-level application, which would "recognize the differentiated interests of employees" and contribute to "shaping the different realities of individual branches and enterprises" (Deutscher Gewerkschaftsbund [DGB], 1996, p. 14). For their part, the employers' associations have made more far-reaching proposals in the direction of turning the sectoral contract into a framework agreement, within which the substantive negotiations take place at the enterprise or workplace level. This has been the goal of Gesamtmetall for the metalworking and electrical branches since 1996:

(1) Reduction of the contents of sectoral collective agreements to a few core regulations applicable to all members. These include percentage changes in wage rates and salaries, the level of base pay, the number of working hours on which wages and salaries are gauged, vacation time, the level of overtime and bonus payments, agreements supplemental to legal provisions governing such items as dismissals, and regulations for consultation and mediation.

(2) Definition of additional regulations, which are not binding for all parties to the sectoral contract. By this, Gesamtmetall means framework regulations, optional packages for members to choose from, as well as release clauses.

(3) Simplification of contract negotiations through interlocking negotiating commissions and steps toward centralization (Gesamtmetall, 1996; 2002).[7]

In some sectors, this has even been put into practice (Dörflinger, 1996, p. 21). For the associations, it would not be in their own self-interest to eliminate the sectoral contract completely (Schroeder & Silvia, 2003; Thelen & Wijnbergen, 2003); moreover, as even critics of the sectoral contract have pointed out, powerful unions would probably still exist and could force their will on individual enterprises (i.e. large international firms) even more easily.

Considering the importance of the economic sectors for which IG Metall and Gesamtmetall bargain, the progress of their reform efforts will have far-reaching effects on the future structure of contract negotiations in Germany. Many incremental changes of a more pragmatic nature are being implemented that are continually reforming the system. One such agreement, which has become a model arrangement, is the hardship clause (*Härtefallregelung*). This agreement resulted from the 1993 strike in the metalworking industry in eastern Germany and included a provision allowing individual companies to opt out of the contract if they could prove such an option to be essential for their survival. To do this, the firm must receive written permission from a joint board of union and employers' association representatives, which had to reach a unanimous decision based on the economic and financial data it was presented. According to a study of the hardship clause in operation (Hickel & Kurtzke, 1997), this cooperation has not only furthered structural and developmental creativity, it has provided those companies in need with an infrastructural backing. And as opposed to pure release or opening clauses, it has protected works councils from management power plays and allowed the union to keep its reins on the process.

Although such partnership agreements are a tribute to the resiliency of the sectoral contract (Turner, 1998), the climate of constructive conflict partnership (Müller-Jentsch, 1999) has deteriorated at the sectoral level in the past few years. For example, the trend toward a shorter working week described above has come to a halt. Not only is the actual level of working hours per week at 40-plus considerably higher than the contract provision of 35 hours (in western Germany), but employers across all sectors as well as politicians have been calling for a lengthening of the workweek as a means of bolstering the economy and combating unemployment. Interestingly, this thrust has come on the heels of the IG Metall's failure to extend the 35-hour provision in the engineering and automotive sectors to eastern Germany. Massive employer resistance buttressed by negative media coverage of the union's position along with strategic deficiencies and leadership conflicts within the union led to the resounding defeat for IG Metall (Schmidt, 2003).

3.2. The Spread of Workplace-Level Bargaining

The general climate of deregulation and decentralization has strengthened the trend in the German collective bargaining system to “soft law” agreements, that is recommendations by the sectoral bargaining agents for company-level agreements on a variety of topics (Bahnmüller & Bispinck, 1995, p. 157). Much of this was generated by the “Volkswagen model”, a highly respected agreement that went into effect in January 1994 and saved some 30,000 jobs by reducing the average number of weekly hours to 27½ (Hartz, 1994; Volkswagen AG/IG Metall, 1994). Both the employers and the union viewed the possible dissemination of such an accord throughout the industry favorably. But the company-level job coalitions that first ensued turned into something different from what the IG Metall had intended (Zeuner, 1996). Instead of giving up a pay increase to create new jobs, works councils found themselves negotiating pay cuts (within the limits of the sectoral contract) to *secure* existing employment and prevent further dismissals (Rosdücher & Stehle, 1996, pp. 319, 325).[8] For the unions, this variety of social partnership offers little support for regaining a strategic offensive (Fichter & Greer, 2004).

Legitimate negotiations with works councils at enterprise level on the basis of the sectoral collective agreement have increased in complexity, which is a sign that sectoral contracts have become less comprehensive and detailed. It is also a sign of the readiness and capability of enterprise-level actors to work out customized agreements on their own, generally under the watchful eyes of the sectoral bargaining partners, but not always. According to recent studies, such agreements now cover not only employment security issues, but they also include pension funds and individual bonus regulations (Streeck & Rehder, 2003).

Shifting bargaining responsibility to the enterprises also means that the role of another key feature of the German Model, works councils and codetermination, is undergoing change. As institutions of company-level decision-making processes, both have contributed to a climate of negotiation and interest compromise that has had, as most observers would agree, a positive effect on the past stability of the German economy and its ability to cope with adjustment (Bacon et al., 1996). Nevertheless, even those who champion the system fear that it is in danger of being unable to successfully deal with the reality of job losses, outsourcing, and the increasing mobility of capital and labor (Dieterich, 1997, p. 3). Also, the weakening of the “corset” *Flächentarifvertrag* in the interest of more tailored-to-fit workplace agreements increases the burden on works councils. Their reactions and ability to cope with this new responsibility seem to be mixed. A survey of IG Metall works councilors, conducted in 1997 and again in 2001, came to the conclusion that the protective function of the sectoral contract is diminishing, making it increasingly difficult to defend employee interests and control the employers’ demands on and for labor. Many felt that while this was not the intended result of the union’s policies, they were left to fend for themselves with an ever-decreasing arsenal of defense (Bergmann et al., 1998; 2002).

While recognizing such difficulties, other observers consider the system to be basically sound but in need of revised concepts of its functionality. As Müller-Jentsch and Sperling have pointed out, creating new patterns of work organization and introducing concepts of group and individual responsibility present challenges to the existing channels of interest representation and dialogue. But in the end, management needs the works council for the social rationality this body guarantees as a prerequisite for economic efficiency (Müller-Jentsch & Sperling, 1998, p. 76; see also Baethge & Wolf, 1995, p. 243). In the view of Horst Kern, however, the well-trodden paths of social communication – including those closely associated with all aspects of production and innovation – are a two-edged sword, both useful and detrimental under the demands of change. The relationship of trust between management and employees, one of the pillars of the system, has on the one hand broken down under the growing economic pressures with which firms are faced. On the other hand, reliance on existing relationships of trust can be a drawback if it excludes the uncertainties of revising the old or entering into new relationships. "Too much trust in the familiar can be an expression of an extremely unproductive view of matters, and a shot of mistrust can be productive." (Kern, 1996, p. 12) Kern does not however present any hard evidence that the system of codetermination is a cause of the generally recognized German weakness in basic technological innovation. Should this be borne out, revisions to the system could include both a relaxing of legal regulations and procedures, and providing works councils with greater incentives to contribute to the development of production and market strategies (Nagel, 1996, p. 107).

3.3. Trade Unions and Employers' Associations as Membership Organizations

Compared to the rapid and massive declines in membership that unions in other industrialized countries were going through by the early 1980s, the unions within the DGB continued to maintain a relatively high level of organizational coherence throughout the decade prior to unification. Membership levels stagnated around 7.8 million, while organizational density declined marginally from 33.4% to 31.8% in 1989 (Schmitz et al., 1991, p. 88).[9]

In the course of their organizational build-up in eastern Germany in the years 1990 and 1991, the DGB unions signed up over 4.1 million new members, increasing overall membership by more than 50%. However, that success story could not hold up as massive de-industrialization and soaring unemployment engulfed eastern Germany (Fichter, 1997). By the end of 1992, some 1.6 million industrial jobs had been lost, and union enrollment in the new *Bundesländer* fell off by 800,000. Ten years later (2002), the DGB unions had only 1.3 million members in that part of Germany. By comparison, in western Germany membership losses during this time period amounted to some 17%. Although the overall decline has tapered off in the past few years, total membership in the DGB unions was down to 7.7 million at the end of 2002 (Schroeder & Weßels, 2003, p. 634).

Post-unification membership and financial problems have been a decisive impulse for the wave of mergers within the DGB. The DGB's organizational structure at its founding in 1949 remained virtually intact until the 1990s. Today, the DGB is composed of only eight industrial and multi-industry unions.[10] The latest, and largest, of these mergers was completed in 2001, when a new service sector union, ver.di, was launched. Founded by four DGB unions and the former white-collar union DAG, it is larger than the previously dominating IG Metall. Today, it is beset with considerable organizational and financial problems and, for many, has yet to realize its proclaimed goal of better representation of the membership (Keller, 2001).

Such restructuring is designed to stabilize jurisdictional coverage and strengthen the unions' capacity to represent their members and provide expected services. Some of the smaller unions were unable to operate effectively without the financial support of the DGB even before German unification. But organizational expansion to the East suspended any consideration of reform, and only in its wake, with traditional organizational divisions and jurisdictional agreements called into question by continuing membership decline, enterprise restructuring, technological and product development, as well as changes in the production chain, have the DGB unions latched onto the merger strategy as the most appropriate answer to their problems.

Besides the question of the future of the DGB as a federation in this new constellation (Fichter et al., 1996), the unions will have to show that they are more than just organizational agglomerations and that the identification of their members with the organization will not be lost in the shuffle. Most unions have initiated projects to adjust their organizational structures and streamline administrative procedures; but it is uncertain whether restructuring will achieve the projected results (Behrens et al., 2003). Unions thrive on solidarity and the engagement of their members on behalf of ideals as well as material goals. The creation of new and enlarged union structures presents a problem similar to the recognition gap already faced by the unions in the new *Bundesländer*. Even the powerful IG Metall has found that its strength in that part of the country is quite limited, as the lost strike of 2003 clearly showed (Schmidt, 2003). The perceived advantages of size will not find the acceptance of the members if it fails to open the way for the creation of a new organizational identity through recognized and effective rights of participation (Schnabel & Pege, 1992, pp. 122-123.).

Employers' associations have also suffered considerable losses in membership since unification. Growing international competition has fueled massive conflicts of interest; for example, in the automotive industry between the large car manufacturers and their smaller suppliers over wage settlements negotiated by their common employers' association. Smaller enterprises have increasingly protested that the agreements are too costly and as such feel that their interests have not been adequately represented. This process seems to be the result of what Klaus Dörre has called the "loss of the convoy escort" (*Verlust des Geleitzugeffekts*) in referring to the ways in which key enterprises in a particular sector are increasingly passing on cost reduction and flexibilization demands to smaller suppliers while using their transnational positions to avoid domestic social costs in Germany (Dörre, 1998, p.

128). This conflict of interests is particularly evident in the large employers' association Gesamtmetall, but is of no less concern to a number of other associations; for example, in the pharmaceutical industry (Schnabel, 1995, p. 59).

Although there are many different reasons given by firms for joining or leaving an employers' association, including primarily economic ones such as buy outs, restructuring or outsourcing (Schnabel & Wagner, 1996, p. 293), the importance of the employers' association as a "counterweight and negotiating partner to the unions" (Vieregge, 1993, p. 744) seems to be an especially key factor. In the past, this has been a decisive criterion for joining; in the meantime, as the protective function of the sectoral contract wanes, this ranks highest on the list of reasons given by companies for leaving their association. In a study of the membership fluctuation in four regional employers' associations of the metalworking and electrical industries, dissatisfaction with the negotiated contract agreement was on the list of the reasons given by 75% of firms that had canceled their membership. A distant second on the list was dissatisfaction with the level of dues (37%) (Schroeder & Ruppert, 1996, p. 41). Another survey has shown that, along with the size of the company, its age was also a factor in determining membership in an employers' association. Also, avoiding the binding character of the sectoral collective agreement is an option if the risk of a strike is minimal and the level of unionization in their company is low. Especially newer, smaller, and more flexible enterprises are untouched by the traditional elements of labor relations regulation in Germany (Schnabel & Wagner, 1996, pp. 301-303).

4. CONCLUSION

Will the model become obsolete or dysfunctional as a result of the practices tailored to the overpowering influence of institutionally unfettered market competition on a global scale; or will the institutional framework for regulating labor and labor relations in Germany, which has proven to be resilient and adaptable in the past, continue to evolve incrementally, reforming to the extent necessary to retain its status as the accepted mode of interaction?

The interaction of institutional resiliency and actors' choice has led to considerable, and yet still manageable, modifications in the system. In practice, the heterogeneity of the German Model incorporates a pragmatic strength of conflict and cooperation, which enables incremental change and adaptation. The key issue that will ultimately determine the future course and design of labor relations in Germany is whether the model continues to be an instrument of interest regulation and conflict resolution that can provide all relevant parties with otherwise unattainable advantages. Structural changes and actors' choices in the national context are increasingly influenced by exogenous factors, bringing new contingencies into the process, especially since the actors – and, in part, the institutions as well – may represent interests and constituencies outside of the heretofore accepted territorial arena. New constellations of institutions and actors, for example, on the European level, will arise in the process, affecting the complexion of the German Model.

The advent of social pacts throughout Europe over the last decade (Hassel, 1998 for western Europe; Héthy, 1995 for eastern Europe) may be helping smaller countries to bolster their international competitiveness; but in Germany, this approach in the form of the "Alliance for Jobs" (*Bündnis für Arbeit*) has had a poor track record. A national retrenchment policy (Streeck, 1998) around neo-corporatist arrangements is ill-suited as an instrument of reforming the system to meet current challenges. Alternatively, in light of the differentiation scenario referred to above, the prospects of a system of multilevel regulation (Dörre, 1999), integrating European and German elements, would at present seem to offer the most reasonable chance of steering a constructive course of adaptation, while retaining most of the protective elements that have been the hallmark of the system in the past.

Ultimately, it is less the forces of "erosion" than the strategies and power of employers, unions and government as organized actors that will determine the future course of change. Employers have both effected changes in their interest and profited from global and social structural changes. While their power has increased, the power of unions has waned. Regaining the initiative and reframing the power equation will require new strategies and perspectives on the part of unions (Hyman, 1999; Frege & Kelly, 2004). Necessarily, such steps of revitalization will be based on historical antecedents coupled with a variety of new and experimental initiatives perceived to be relevant to the peculiarities of the German experience (Waddington, 1999). Evidence of a turnaround in this process is still scanty, but the potential ramifications are of global dimensions, making its inclusion in the social science research agenda imperative (Fairbrother & Yates, 2003; Turner, 2004).

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NOTES

1 One of the union projects, called *connexx.av*, which was initiated at the time in the media sector of the New Economy, has been unexpectedly successful. See http://www.connexx-av.de for more information.

2 A legal minimum wage has been implemented in the construction industry in conjunction with the posted-workers' directive and based on the currently valid collective agreement. Since the early months of 2004, the question of legislating a minimum wage has become an issue of public debate.

3 This principle applies only to the DGB unions. The major unions competing with the DGB have been the Deutsche Angestellten-Gewerkschaft (DAG), which represented salaried employees until it merged with several DGB unions in 2001 to form the public service union ver.di; the major civil service association Deutscher Beamtenbund (DBB) and the small Christian union CGB. For membership figures consult the respective internet homepages.

4 See http://www.polwiss.fu-berlin.de/tu/links.html for listings of the internet websites of German unions and employers' associations.

5 The "dual system of training" has a long institutional history (Thelen 2004). It's effectiveness is currently part of the overall debate on labour market regulation.

6 According to government statistics there are around 1,100 sectoral and regional collective bargaining units in Germany. Over 59,000 collective agreements are in effect. (WSI-Tarifhandbuch 2004)

[7] An insightful and usually well-informed observer, Hans Mundorf of the *Handelsblatt* reported only a few weeks after the reform project was announced that Gesamtmetall headquarters had failed in its attempts to win support within the regional associations for centralizing contract negotiations on the employers' side (Mundorf, 1996, p. 5).

[8] In their comparison of concession bargaining in the U.S. and "employment securing" collective bargaining in Germany, Rosdücher and Stehle point out that in regard to the extent and intensity of the agreements analyzed in both countries, the German unions and works councils had to make less concessions than their American counterparts.

[9] These are the DGB's own figures, and since they do not include the unemployed, whose number rose from over 800.000 at the outset of the decade to 1.9 million in 1989, they are somewhat misleading. When the unemployed are included, the rate of organizational density drops from 33.7% (1980) to 30.5% in 1989.

[10] In 1978 the previously independent police union GdP joined the DGB, and in 1989 the first merger took place between the printers union and the artist union to form the *IG Medien, Druck und Papier, Publizistik und Kunst*. See http://www.dgb.de

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Chapter 6

CHRISTIAN KELLERMANN

DISENTANGLING DEUTSCHLAND AG

1. INTRODUCTION

The expression "*Deutschland AG*"[1] ("Germany Inc.") is commonly used for the tight entanglements between private banks and industrial corporations, which are typical for the *German Model* ("Modell Deutschland"). These entanglements take the form of a vast network between the financial and industrial sector consisting of personal, as well as financial ties. Often the German Model is also described as "organized capitalism" (Streeck & Höpner, 2003, p. 15), because these networks allowed for the steering and the protection of the economy to a relatively high degree – in contrast to the Anglo-Saxon Model, which is more open-market-oriented. Deutschland AG's networks originate in the early post-war reconstruction era and helped to initiate the German "*Wirtschaftswunder*", the economic miracle of the 1950s and 1960s. Its long-standing success is often credited to the institutional complementarities of capital and labor having promoted a "dynamic efficiency in production and incremental innovation in products and process" (Jackson, 2003, p. 261), reinforcing a stable path of organizational learning and growth. Such institutional configurations determine the *center of gravity* of an economic system, either in a more corporatist direction or in a more liberal one. At the core of Germany's steep and steady way to become one of the leading economies in the world lies its unique system of corporate governance, which encompasses all major stakeholders (unions, banks and industry) and enables long-term oriented corporate policies.[2] Deutschland AG and its distinctive mode of corporate governance are the key components of the German Model (see the introduction to this book for a detailed description of the characteristics of the German Model); since the 1990s this system has come under considerable pressure to adapt to a more market-oriented system, like the U.S. type.

This pressure is primarily rooted in the German financial sector, which is traditionally characterized by the existence of large universal banks that are heavily engaged in cross-shareholding and debt-financing of corporations. With the onset of the 1990s these banks aspired to become global investment houses (like their U.S. competitors) initiating a fundamental dynamic of change in the relationship between finance capital and corporate industry. This dynamic can be summarized as a "pressure to liberalize Deutschland AG's corporate governance institutions in line

S. Beck, F. Klobes, C. Scherrer (Eds.), Surviving Globalization?, 111—132.

with prevailing Anglo-American practices to promote greater transparency and shareholder returns" (Jackson, 2003, p. 302). Additional pressure came from the increasing role of capital markets for corporate financing and from the perception of the superiority of the U.S. model, especially in light of the success of the "New Economy".

Although it is almost unanimously agreed on that there *are* substantial changes of Deutschland AG and its mode of corporate governance, there is no consensus on how far this process might go. Some analysts argue that national characteristics will prevail observing more of an incremental, path dependent change (e.g. Vitols, 2003a; 2003b), while others ascertain a major degree of international convergence towards a U.S. style shareholder model (Kellermann, 2002). Outside the academic field, this matter is discussed comparatively passionately, a fact that is attributable to the ideological power of shareholder value symbolizing socio-economic doom for critics and cure for supporters. Critics of an increasing focus on shareholder value fear that this process will ultimately lead to the break-up of the compromise expressed in the system of Deutschland AG. As a result corporate short-termism and hostile takeovers will escalate, and the economy as a whole will be much more prone to market *caprices*. Advocates of shareholder value in contrast call for this change, as Deutschland AG's "insider control system" would encourage a profligacy of resources and obstruct necessary reforms. They stress Deutschland AG's disadvantages against more flexible, market-based systems of corporate governance like the U.S. "outsider control system". Germany's relatively low competitiveness in new growth industries like bio- and information technologies, entertainment and the service sector is taken as empirical validation (Nassauer, 2000, pp. 243-287).

Irrespective of this ideologically charged debate, the hypothesis of this article is that of a far-reaching convergence of the German and Anglo-Saxon systems. To approach this topic, I first outline the characteristics of Deutschland AG, before analyzing the various moments of change in the financial, legal and corporate sphere. The most striking example of change was the hostile takeover of Mannesmann by Vodafone in 1999; this case is also looked at in greater detail. Before drawing a conclusion on the future of Deutschland AG, I look at some of the main features of change and discuss some of the inherent risks of the ongoing process.

2. CHARACTERISTICS OF DEUTSCHLAND AG

The German Model codifies the integration of different groups into corporate decision-making, which is one reason why Deutschland AG is often dubbed as a stakeholder system (stakeholders such as the workers, a bank or the state), whereas the Anglo-Saxon model is typically labeled a shareholder system (i.e. many anonymous shareholders). Within the latter system equity markets play a much more dominant role in the relationship between owners (shareholders) and the management (agents) of companies. Deutschland AG's stakeholder system, by contrast, is characterized by strategic long-term investments of a private bank in

large industrial companies as well as institutional rules that allow for an investor's representation in a company on the supervisory board.
Three main pillars characterize the German system of corporate governance:

(1) The dominating role of banks in corporate financing and on supervisory boards;

(2) the system of industrial relations with its codetermination (*Mitbestimmung*) at the plant and at the supervisory board level, and

(3) a company- and production-centered management system (Jürgens & Rupp, 2002, p. 2).

I will focus on (1), the relationship between banks and industrial enterprises called the Deutschland AG, but will also look briefly on how changes in this relationship have an impact on (2) codetermination and (3) management systems and other issues of corporate governance such as corporate law and accounting standards.

The German Model of corporate finance demonstrated its full strength in the reconstruction period after World War II. As capital markets would not provide for the financing of industrial reconstruction (two lost world wars had impoverished the German bourgeoisie), bank capital became the vital factor of growth, and, hence deeply entangled with industry. Tax policies, which bolstered bank loans and discouraged equities or bond issues for industrial corporations (cf. Vitols, 2003a, pp. 250ff.), as well as many other institutional features of the German economy, such as concentrated ownership, bank proxy votes and supervisory board seats, the two-tiered board structure, voting rights restrictions, accounting and disclosure rules, codetermination, and German corporate culture, reinforced the importance of bank loans vis-à-vis stock markets and led to the specific main bank relationships[3] typical for Deutschland AG.

The private so-called *Big Banks*, currently the Deutsche Bank, Dresdner Bank, HypoVereinsbank, and Commerzbank, predominantly finance the corporate sector. They offer a variety of financial services to their customers, such as the taking of deposits, consumer and commercial lending, securities underwriting, mutual fund operations, and investment advising. This diversification of business areas centers around the classical credit- or interest-based fields of action, which suggested the term *universal banks*.

The public savings banks (*Sparkassen/Landesbanken*) and the non-profit cooperative banks (*Genossenschaftsbanken*) actually make up for the largest market share in Germany's banking system. The main reason (among others) for creating such institutions was to support regional development in structurally weak regions and the financing of small and medium-sized enterprises (SMEs). The prevalence of loans and of the non-profit banking sector for SMEs allowed companies to focus on long term organic growth; this is a central characteristic of Deutschland AG, apparent in the ability to deal with business cycles in a more steady way, since banks have vital interests in the "survival" of the companies they are entangled with. Renewed capital flows and/or the temporary management of the company are more likely to succeed in the restructuring of the company for a "new start". One major effect of this relative steadiness is the encouragement of incremental innovation through the possibility of continuous capital investments as well as research and development (R&D) (Soskice, 1999). Another is the fact that layoffs can be avoided keeping know-how in the company (Streeck, 1997).

2.1. Signal of Change: The Hostile Takeover of Mannesmann by Vodafone

In the past the capital and personal networks of large banks and corporations made hostile takeovers very unlikely. No foreign hostile takeover took place *despite* a relatively low market valuation of potential takeover candidates (cf. Emunds, 2003, pp. 198ff.; Windolf & Beyer, 1995, pp. 22-25). But the walls of "Fortress Germany", as some, mainly Anglo-Saxon, commentators used to characterize Deutschland AG, began to crumble with the successful hostile bid of British Vodafone on Mannesmann in 1999/2000 – an event of systemic relevance (Höpner & Jackson, 2001).

Mannesmann used to be a paradigmatic company for Deutschland AG, with diverse industrial activities and close entanglements with bank capital. The chairman of the supervisory board was the CEO of its house bank (Deutsche Bank), and the representation of Mannesmann employees on the board followed the most expansive codetermination model, the *Montan-Mitbestimmung*.[4] With its traditional steel business in decline, Mannesmann had started to transform and focus on new businesses, first on mechanical engineering and automotive technology, and later, in the mid-1990s, on telecommunication, with astonishing success (Jürgens & Rupp, 2002, pp. 1-2 and 55-56). In October 1999, Mannesmann had agreed to buy U.K. mobile operator Orange, in November, that is in reaction to that move, Vodafone made a counter-bid for Mannesmann, mainly for two reasons: On the one hand Mannesmann's successful telecommunication business fitted into Vodafone's global aspirations (with Vodafone taking over AirTouch earlier in 1999), on the other hand Vodafone saw its own strategic interests threatened by Mannesmann's plans in Britain.

One major sign of the erosion of this Deutschland AG-relationship was the fact that Mannesmann's main stakeholders, Deutsche Bank and the workers' union IG Metall, followed the takeover with a "benign neglect"; in fact they not only accepted the takeover bid, they silently approved of it: "There was no mobilization of Deutschland AG", says Ulrich Jürgens (ibid., p. 56), an expert on German manufacturing. One reason for this "silence" can be traced back to Deutsche Bank's unfortunate role in a takeover-battle prior to this case, between Krupp and Thyssen in 1997, which severely conflicted with its new focus on the investment business. That was because on the one hand Deutsche Bank had a seat on the supervisory board of Thyssen, and on the other hand they supported Krupp in its strategy to take over Thyssen, provoking not only angry public protests, but also a basic conflict on the board itself between traditionalists (“universal bankers”) and investment bankers. Since the latter won this controversy, they pressed for “neutrality” of their house in the takeover-battle between Vodafone and Mannesmann (cf. Höpner & Jackson, 2001), but neutrality in this case was synonymous with silent support.

Two aspects are important for understanding the union’s behavior: First, Mannesmann’s business fields were extremely heterogeneous at that time, with an immense overweight in telecommunications at the expense of the other fields of activity. Unions and labor representatives pushed a plan to split up the corporation in order to reconstitute an independent development of Mannesmann’s traditional business divisions. Until then the “conglomerate discount” made necessary acquisitions more expensive, hence securing the support of shareholders as well as labor representatives (cf. ibid.). Second, Klaus Zwickel, head of IG Metall and member of the Mannesmann supervisory board, stated that since the chairman of the supervisory board, at that time Deutsche Bank’s CEO Klaus Ackermann, had a double voting right he could not stand against the takeover including the bonus payments (“golden handshake”) of around Euro 60 million. to the Mannesmann-CEO Josef Esser and other executives, who are currently under trial (2004) for bribery. Just as the takeover demonstrated the beginning of the end of Deutschland AG, the trial reflects the frictions between Corporate Germany and the shareholder system.

Furthermore, the takeover was managed via the capital market in form of stock swaps, which manifested the beginning dissolution of bank and industrial capital in Germany in a curious way:

> “Mannesmann’s size, excellent share performance, and use of less transparent accounting standards failed to protect it from takeover through a cashless share swap from its smaller but highly capitalized U.K. competitor.” (Jackson, 2003, p. 284)

To sum up this hostile takeover’s systemic implications for Deutschland AG, it is notable that its usual features to discipline the management were ineffective, such as the concentrated ownership structures, the power of the large banking institutions, the insider system of corporate governance, and the strong position of unions and labor representatives in a company. Earlier attempts for hostile takeovers (e.g. Continental by Pirelli or Thyssen by Krupp) failed for some of those reasons, and not the least on moral grounds. During the Mannesmann case there was no question of legitimacy about the takeover itself.

This often-cited example reveals many moments of change within Deutschland AG: First, the growing importance of financial markets in Germany, second, the tendency of large commercial banks to withdraw from their traditional role as house bank to industry, third, concentration of a diversified company on the most profitable core business, and fourth, the loss of power of traditional stakeholder groups such as workers’ representatives in corporate governance. The key driving force behind this change is the growing importance of shareholder value rooting in the financial sector and having considerable spill-over effects on Corporate Germany spurring consolidation and strategic alignments of business fields.

The hostile takeover of Mannesmann by Vodafone marked only the beginning of a new at-arms-length relationship between banks and industry and not the end of it. In fact there is still a relatively high degree of mutual stakeholding in Germany's 30 largest companies. In 2002, large chunks of the stocks of half of these 30 companies were either held by the founding family (e.g. the Siemens family held 6.9% of Siemens AG) or by another company (e.g. Siemens AG held 71.9% of Infineon). A bank, an insurance company, or the state held large stakes in the other half (cf. Vitols, 2003b, pp. 141-142.). Encouraged by the elimination of the capital gains tax in 2002, most of these stockholding institutions announced plans for disengagement. A broad-based trend towards dissolution of the intercompany shareholdings is in the making (O'Sullivan, 2003, p. 47).

3. FINANCIAL DYNAMICS

Change of the German Model began with dynamics in the financial sector[5] a decade or so before the Mannesmann-bid by Vodafone. The most important *market changes* promoting a refocusing of banking activities can be summarized with the following five trends (cf. Börner, 1998, p. 35ff.):

Globalization: Many banking activities and business areas expanded from the national to the international level. This was mainly caused by the introduction of new information and communication technologies (ICTs), which allowed for a further dematerialization of banks' main asset, money. Money, unlike other goods or products, is highly mobile. Globalization of financial institutes' business areas and range of action further correlates with globalization trends in industrial capital. Large companies can attract capital on international financial markets under more favorable conditions, which promoted the growing tendency of disintermediation, that is the marginalization of banks in their original role as credit/money-intermediaries. The structural prerequisite for the globalization of finance capital was the political deregulation and liberalization of capital markets (cf. Swary & Topf, 1992), the break-up of the Bretton-Woods system of a fixed exchange rate regime and the abolition of capital controls. Before that, trans-border financial activities were highly regulated, in many cases impossible (cf. Huffschmid, 1999; Guttmann, 1994).

Securitization and investment banking: The increasing substitution of credit money by recourse to financial markets for corporate bonds and equity capital increased the importance of the Anglo-Saxon model of investment banking in Germany, because this market was primarily controlled by foreign investment houses. This trend was further reinforced by a wave of mergers and acquisitions (M&As) within the industrial sector, privatization of state firms (cf. Huffschmid, 1999, pp. 74-78) and the booming business of initial public offerings (IPOs) which gained momentum particularly after the establishment of the *Neuer Markt*, the stock market segment for start-up companies; the years 1998, 1999 and 2000 were all record-breaking years (by the measure of IPOs and in comparison to the main market – "*Amtlicher Handel*") (O'Sullivan, 2003, p. 48).

Trading: Commercial banks' own trading activities became more important; this happened in the context of modern ICTs and the globalization of their business:

> "The growing competition within the banking system rendered trading around the clock, around the world as a special field of investment banking an essential cornerstone of banks in general." (Börner, 1998, p. 35)

Indicators for the growth dynamic as well as the high degree of competition in the trading business are strong volume growth rates and the emergence of all kinds of financial innovations such as derivatives.[6]

Differentiation and rationalization of distribution channels: Retail banking in particular is under pressure for restructuring, whereby ICTs again play a central role, as they provide the basis for the multiplication of distribution channels for financial services (telephone banking, electronic direct banking etc.) (European Central Bank [ECB], 1999, pp. 5ff.). The thinning-out of branch networks in, as often stated, "overbanked" Germany has been observable since 1992 (Koch, 1997, p. 78). Customer advisory services and transaction settlements are removed and back-office fields are centralized, rationalized and transformed into so-called bank factories (ECB, 1999, p. 7; Ruff, 1999). One motivation for these processes is a relatively low return on equity (RoE) of German banks compared to international standards. At the end of the 1990s RoE was at about five percent, one of the lowest values internationally compared (Europäische Kommission, 2001).

Shareholder value: The focus on shareholder value relates with the trends of globalization and investment banking. While this practice is not confined to the financial sector, it is deeply rooted in the banks' concern to restructure and consolidate in the wake of the above challenges. In practice shareholder value is a management concept, whose central criterion for an effective corporate policy expresses itself in an above-average increase of return on equity for the proprietors of the capital stock (Rappaport, 1986). Banks focused on the increase of shareholder value according to Alfred Rappaport's concept for several reasons: To create a powerful "currency" in the form of their own stocks for takeovers of other banks, to defend against hostile takeovers themselves, and to justify their new focus on investment banking with the corresponding restructuring and layoffs.

4. PRIVATE BANKS AS THE MAJOR ACTOR

The above-mentioned trends led to widespread changes in the German financial system during the 1990s. Foremost, the Big Banks adopted new business strategies and, together with the emerging new institutional investors, forced change on the non-profit financial sector and on industrial enterprises.

4.1. From Universal to Investment Banking

Germany's universal banks underestimated for long the growing importance of investment banking. Next to some considerable degree of managerial neglect, this can structurally be traced back to historical particularities in the banking systems, especially if compared to the U.S. system. One key feature of universal banks has always been the possibility for a bank to be engaged in the deposit, credit and securities business at the same time. By contrast, the U.S. as well as the U.K. banking systems were affected by the experiences during the great banking crisis in the 1930s, which led to the creation of a separated and therefore highly specialized banking system, according to which banks could either be engaged in the deposit and credit *or* in the securities business (Glass-Steagall Act of 1933). Deutschland AG's main characteristic of industrial shareholding rendered obsolete for a long time the development of investment banking as an individual field of action for German banking institutes. This explains in part the dominant position of U.S. investment houses in Germany and elsewhere (cf. Huffschmid, 1999, p. 79).

It was not before the 1990s until Germany's Big Banks aspired to expand into the then highly profitable field of investment banking and asset management, with considerable spill-over effects on Deutschland AG and the German Model. Sigurt Vitols aptly emphasizes:

> "In Germany, reform has been driven for the most part by the large banks, which desire to create a home base supportive of global-player investment banks on the U.S. model." (2003a, p. 259)

Being "multi-specialized" means the end of universal banks' old "vendor's tray principle" and a focus on the most profitable business areas.[7] Single business areas that cannot meet capital costs no longer get cross-subsidized, since cross-financing conflicts with the concept of shareholder value – the dominant benchmark for financial institutes since the onset of the 1990s:

> "Banks have to respect […] – like any other company – the interests of investors more and more. They have to orientate themselves – to use a highly controversial and emotionally loaded term here – by the shareholder value",

says Deutsche Bank's Chief Economist Norbert Walter (Walter, 1999). The investment focus also urged banks to divest from large stakes in industrial corporations, since too tight entanglements may lead to conflicts of interest between a bank's investment strategy and insider information.[8]

The prevailing strategy to close this *gap* between the German and U.S. system and to meet the new competition were mergers and acquisitions (M&As). Since the mid-1990s, a growing number of mega-mergers in the sector were observable. Mergers were mainly characterized by national outreach, and whenever there was a cross-border merger, it was a large bank taking over a smaller institute, as in the case of the acquisition of the derivatives branch of the British National Westminster Bank by Deutsche Bank (cf. Huffschmid, 1999, p. 69). Those M&As were largely driven by the expectation to profit from economies of scale and synergetic effects. The concentration in the financial sector is further being accelerated by the unification of the European financial market. There were 215 M&As in the period from 1991 until 1998 in the German banking sector; in the years 1997/98 banking M&A activity made up 54.6% of M&As in all industries (compared to 11.2% for the U.S.; source: White, 1998, p. 37).[9]

Banks' reorientation and consolidation in the course of the concentration on the investment business and shareholder value corresponded with and promoted the growing importance of capital markets in Germany. This in turn was the precondition for new financial actors, specialized on investment and asset management, to emerge.

4.2. The Emergence of Institutional Investors

There are three large groups of institutional investors: Capital investment groups (e.g. unit trusts, but also highly leveraged institutions like hedge funds), pension funds (receiving their capital from financial pension contributions of employers) and insurance companies. The U.S. example demonstrates the degree of power and influence institutional investors are able to wield. In the second half of the 1990s professional U.S. institutional investors managed more than 50% of the cumulative financial assets, while in Germany this proportion amounts to only 19% (cf. International Monetary Fund [IMF], 1997, p. 135). The largest group of institutional investors in Germany is the insurance industry (Bank for International Settlements [BIS], 1998, pp. 94-99). As can be observed from the U.S. example of capital coverage of retirement provisions and the dominant role of such pension funds in an economy (Huffschmid, 1999, p. 88), there is a strong trend for M&As in Germany to achieve similar dimensions. The acquisition of Dresdner Bank by Allianz Insurances in 2001/2002 is the latest and most striking expression of the most obvious strategy to reap the enormous potential of the German pension reform.[10] This merger allowed the marketing of all kinds of pension products from one source (cf. Deutsches Aktieninstitut [DAI], 2001). Similar endeavors of insurers and banks are observable with other institutes: Münchener Rückversicherung, the second big insurer in Germany, took over Allianz shares in HypoVereinsbank, and Commerzbank also has existing interconnections with an insurance company (Generali in Italy) – a trend that is commonly called “all-finance” (*Allfinanz*) or “one-stop finance”.

4.3. The Future of Public Banking

As has already been mentioned, the German financial system features two more types of banking institutes: The public savings banks – *Sparkassen* (municipal savings banks) and *Landesbanken* (regional savings banks at state-level) –, which account for approximately one-half of all banking system assets, and the credit cooperative banks (*Genossenschaftsbanken*), which account for about 20% of banking system assets (cf. Vitols, 2003a, p. 251).

The main reason (among others) for creating such institutions was to support regional development in structurally weak regions and the financing of SMEs, a central feature of the German Model.[11] For this purpose there existed a warranty liability (*Gewährträgerhaftung*) and the institution burden (*Anstaltslast*) of the public owners, which allowed for smaller equity capitalization and the granting/extension of loans to weaker enterprises; within the latter, savings and regional banks have a market share of about 75% (Beck & Scherrer, 2003, p. 744).

Currently public banking is under pressure to adapt to market orthodoxy, stemming both from within the savings banks, notably the large ones[12], and from the private banking sector. The latter accuse the public sector of distorting the national market due to their "*social contract*", and therefore of being jointly responsible for private banks' high losses and unprofitability by the turn of the millennium. Due to EU competition policy, the German system of savings banks is being changed in a way that the warranty given by the state as bearer of risks, that is constituting a prompt deficiency suretyship, is discarded. This policy is the consequence of a complaint of the European Banking Association (EBA) with the EU-Commission in 1999 (*EU-Beihilferecht* or EU Law on Government Aid). The process began with the transformation of the *Landesbanken*: The abolition of the state warranty increases borrowing costs on financial markets for those regional banks, which in turn bear the refinancing of most savings banks; hence, their core business, the commercial lending business with SMEs, is now more costly and consequently handled more restrictively, having contractive effects on the performance of the German economy (cf. "Without Credit", 2003), particularly in East Germany (cf. Beck & Scherrer, 2003, p. 744).

The structural and operational dynamics in Germany's financial sector led to the emergence of very large and powerful financial institutions that exert considerable influence on the economy as a whole and also on the legislative process. Another major driving force for change in financial regulations in Germany in the 1990s was a shift in Big Banks' interests, with the National Association of Private Banks (*Bundesverband deutscher Banken*) taking the lead in making policy proposals (Vitols, 2003a, p. 252); a closer look at these innovations is necessary.

5. LEGISLATIVE INNOVATIONS

From the 1990s until today there have been a number of legislative initiatives that led to an erosion of Deutschland AG's pillars. The way that these legislative changes were brought about clearly showed that

> "[…] political interests seem to be influenced in an important way by the economic context in which they operate. […] There is a need to look at the actual power that various interest groups have in the corporate economy as well as in the political system." (O'Sullivan, 2003, pp. 63-64.)

The role of the government was mainly reduced to arranging the legislative process and drafting various versions of the following laws (cf. Vitols, 2003b). [13]

There is a whole canon of Laws that has been initiated: The Second (1994), Third (1997), and Fourth Financial Markets Promotion Laws (2002) (*Zweites, Drittes, Viertes Finanzmarktförderungsgesetz*). The Second Financial Markets Promotions Law marked "the most important step toward establishing U.S.-style regulation of capital markets" (Vitols, 2003a, p. 252), as it established an independent regulatory agency (*Bundesaufsichtsamt für Wertpapierhandel*) for surveillance of the financial market, modeled on the U.S. Securities and Exchange Commission (SEC), and a set of rules for dealing with insider information (cf. Sablowski & Rupp, 2001). The Law on Transparency and Control in Corporations (*Gesetz zur Kontrolle und Transparenz im Unternehmensbereich*, KonTraG) in 1997 authorized stock option plans and the buyback of shares (an initiative of industry and banking associations); a number of provisions increased shareholder value's influence within the German Model, such as multiple voting rights and the removal of voting rights restrictions. Furthermore, banks could no longer use proxy votes if their direct shareholding exceeded five percent; and the supervisory board was strengthened (cf. Jackson, 2003, p. 270). According to the Association of the German Industry (*Bundesverband der Deutschen Industrie*, BDI) KonTraG increases the efficiency of company bodies in line with financial market requirements (BDI & PricewaterhouseCoopers [PWC], 2001, p. 36). Additional innovations were the Law on Reform of Commercial Law (*Handelsrechtsreformgesetz*), the Law on Registered Shares and the Facilitation of Voting (*Gesetz zur Namensaktie und zur Erleichterung der Stimmrechtsausübung*, NaStraG), the Law on Acquisition and Purchase of Securities (*Wertpapierserwerb- und Übernahmegesetz*, WpÜG), and the Law on Facilitating the Raising of Capital (*Kapitalaufnahmeerleichterungsgesetz*, KapAEG). At the beginning of 2004 the Law on Modernizing Investment (*Investitionsmodernisierungsgesetz*), which has considerable consequences for alternative asset investments, took effect: For the first time in Germany, the distribution of so-called hedge funds was allowed. This change affects *Dachfonds* (funds of funds) as well as investing in single or target funds (*Zielfonds*). Unlike other investment funds, hedge funds are largely unregulated; they "move in a regulatory and supervisory no man's land" (Deutsche Bundesbank, 1999, p. 38; translation: CK). They can take high risks without hedging (the name hedge fund is therefore very misleading), which might yield extraordinary high returns, but sometimes also spectacular losses (e.g. Long Term Capital Management, LTCM, in 1998). According to the National Association of Alternative Investments (*Bundesverband Alternative Investments,* BAI), the *Investitionsmodernisierungsgesetz* is the most liberal regulation in Europe ("Bundesregierung lockt", 2003). Alternative investment classes have proved increasingly popular, as equity returns have suffered. According to Deutsche Bank Research, European hedge funds' assets under management more than doubled form just under 14 billion U.S. dollars in 1998 to 30 billion U.S. dollars in 2001. Hedge fund industry assets are forecast to continue to grow and have average annual rates in excess of 10% per annum over the next five years (*source*: http://www.dbresearch.de).

5.1. Privatization of the Pension System

An especially far-reaching legislative change was the reform of the pension system. While this already drove consolidation in the financial sector (e.g. in form of the acquisition of Dresdner Bank by Allianz Insurances), it may further change the parameters with major consequences for the German Model.

A small but institutionally important first step towards the privatization of the German pension system was taken in 2001 with the co-called "Riester-Rente", named after the Minister of Labor who initiated this reform (for details, see Kai Mosebach's chapter in this book). Here, the main point of the pension reform is the further strain on Deutschland AG as a consequence of increased orientation towards capital market-based provisions and instruments. Focus on shareholder value is more and more important in Germany, since a strong flow of household savings strengthens the stock market (cf. Jackson, 2003). The pension reform has a catalytic effect on the German financial system: In the former combinatory pension scheme of generational apportionment and capital coverage banks cashed in in their function as fund managers in the first place. With the reform of the pension system, private pension provision in form of regular payments in (pension) funds became a vital systemic feature. Since Germany's Big Banks have always dominated the market with mutual and restricted funds, these are basically "arrangements of large financial institutes for large financial institutes" (Bundesverband Deutscher Investment-Gesellschaften [BVI], 1998, p. 52). Four-fifths (Euro 194 billion at the end of 1998) of public fund money is managed by three large commercial banks (Deutsche Bank, Dresdner Bank and HypoVereinsbank) and the central offices of the mutual savings banks (ibid.). Hence the pension reform constitutes a major job enlargement of existing banks in their function as asset managers:

> "As soon as investment banks join into the business with capital market-based pension schemes, they move closer in the direction of the third big group of financial market actors that determines the events on national as well as international capital markets. They become institutional investors." (Huffschmid, 1999, p. 82; translation: CK)

And as interest in shareholder value mounts, so does pressure on Corporate Germany.

6. SHAREHOLDER VALUE AND CORPORATE GOVERNANCE

The dynamics in the national financial sector have substantial effects on the corporate sector of the German economy. Yet, increasing *international* competitive pressure that German corporations are exposed to on commodity and production markets, as well as the enhanced recourse to international financial markets, which demand stronger attention of (international) investors' interests, also exert a considerable strain on the German system of corporate governance by the appreciation of shareholder value issues (cf. Dufey & Hommel, 1997; Organization for Economic Co-operation and Development [OECD], 1995; Lazonick & O'Sullivan, 2000; O'Sullivan, 2003; Yamamura & Streeck, 2003; Vitols, 2003b; Jackson, 2003). In this context, the question is what this new market for corporate governance and control means for Deutschland AG and the German Model? To what degree is Germany about to adopt the Anglo-Saxon Model and give up its corporatist achievements? And would that be a deterioration or improvement for Germany? To answer these questions, a closer look at the application of shareholder value is necessary.

As a management concept shareholder value is rooted in microeconomic calculations: Simplifying the assessment procedure and financial accounting is at the core of this method in order to create an objective benchmark for the comparison of corporation's different strategic options (Copeland et al., 1993). For this purpose, the measurement category "profit" is regarded as an unreliable and therefore inappropriate indicator for the evaluation of a company; a new indicator, the "discounted cash flow" (DCF) is introduced. The DCF is the "sum of liquid resources that is at a corporate disposal for new investments and in particular for the distribution to capital providers in the form of interest and dividends." (Hirsch-Kreinsen, 1999, p. 323; translation: CK) The key aspect of this measurement instrument is the suggestion of an ex-ante view by discounting expected future cash flows on the basis of the bank rate to obtain the present value (Becker, 2001, p. 48). Applying this indicator, a direct comparison of heterogeneous business fields is claimed to be possible, and branch-specific "value-drivers" become the focal point of any management (cf. Black et al., 1998). In this sense, shareholder value is an expression of a commodification of the control and coordination mechanisms within a corporation (Sauer & Döhl, 1997), leading to the concentration on core businesses. The sale or closing down of a business that is not profitable enough and not belonging to the core business therefore became a typical feature of the M&A-wave during the last half of the 1990s in Germany (a characteristic example is the chemical industry, cf. Menz et al., 1999; Becker, 2001; 2003). Deutschland AG's conglomerates or multi-product group corporations were increasingly regarded as being unprofitable and undervalued in capital market terms, since cross-subsidizing of activities not belonging to the core would diminish the company value. The concept says that the company value of a multi-product conglomerate is less than the sum of its single business fields, hence the pressure to restructure.

The rationale behind shareholder value are neo-classical principal-agent assumptions, emphasizing micro-economic allocative efficiency eventually leading to macro-economic welfare enhancement. Defenders of the concept claim that corporations that devote themselves to shareholder value act efficiently and in the long-term interests of their shareholders, but also of their employees and clients, that is their *stakeholders*. The old modus of corporate governance under Deutschland AG, so they say, was too static, as an equal consideration of all stakeholders' interests is not practicable and realizable in any microeconomic praxis. The integrative attempt must lead to a significant deterioration of profitability and the company's market value, while on the other hand a rising market value is the basis for new investment activities (cf. PricewaterhouseCoopers [PWC], 1999). Former measurement categories of traditional accountancy are regarded as unsuitable and ineffectual, as they are not reliably interlinked with a corporation's share price. Additionally, the previously existing margin in accountancy would complicate the international comparison of corporations, and finally the conventional system of indicators is exclusively based on past data and experiences (Becker, 2001, pp. 46ff.). To make sure that the management of a corporation is committed to shareholder value, wage components consisting of stock options and worker participation in the capital of the company are deployed – a crucial signal to financial markets that a corporation is striving to increase its shareholder value (cf. Rosen, 1996). Obviously shareholder value has an impact on German corporations and their governance system.

7. INDICATORS OF PERMANENT CHANGE

In order to be able to speak of a major and permanent change of the German Model, three aspects need to substitute for the old Deutschland AG's mechanisms and entanglements:

(1) The stock market must play a pivotal role;

(2) stocks must be held by investors, whose interests are focused primarily on corporate governance strictly in line with shareholder value principles, and

(3) the organization of companies must promote such an orientation (cf. Hirsch-Kreinsen, 1999; Jürgens et al., 2000; Becker, 2003).

The first aspect, the forces that boosted the stock market in Germany, has been looked at in detail in the first part of this article. The legal initiatives in the 1990s were a strong impetus for the deepening of the German financial market and the creation of a German equity culture (cf. Sablowski & Rupp, 2001, pp. 46ff.). In the period from 1997 to 2001 shares held directly or indirectly by households nearly tripled to 21% (Leven, 2001, p. 1). A major innovation in this context was the already briefly mentioned *Neuer Markt*. Its main index, *Nemax50*, was renamed in 2003 and is now called *TecDax* as a consequence to the particularly spectacular boom-to-bust-phenomenon and the corresponding loss in reputation (O'Sullivan, 2003, p. 56). Despite the substantial bust of this market segment, the wider implications, such as equity markets' role in raising venture capital and the corresponding boom in investment banking, marked a major change for the German Model, for example, the proliferation of U.S. accounting standards (see below). The *Neuer Markt* helped to boost the importance of Germany's financial market in general – notwithstanding the recent decline, in which Mary O'Sullivan sees a "first test of the extent to which a U.S.-style 'shareholder value' regime will become an enduring reality of corporate governance in other countries." (2003, p. 66)

This development coincides with Germany's Big Banks' new investment orientation, supported by the tax reform initiated by the SPD that made capital gains tax-free in 2002, which leads to the second aspect: The emergence of institutional investors, which is a key momentum for the dissolution of the Deutschland AG, as their investment focus is fundamentally different from a house bank's stakeholder interest in a company. The growing short-term orientation of institutional investors has significant spill-over effects on the German system of corporate governance. Institutional investors pool and professionalize former diversified equity holding and savings (Streeck & Höpner, 2003, p. 31), increasing the sums of capital invested by institutional investors. Basically they face two corresponding options regarding a shareholding: "Voice" and "exit". On principle, institutional investors rarely intervene actively to remedy poor corporate performance, preferring exit over voice.

But it is increasingly impossible to separate “voice” and “exit”, since “shareholder voice […] depends on the threat of exit. Institutional investors consult with management largely outside formal institutions.” (Jackson, 2003, p. 283; cf. also Strange, 2002) To exit from an investment, that is to sell a large block of shares, becomes all the more difficult, the larger this block is, as the sale would provoke high price losses. With the amount of invested capital constantly growing, institutional investors tend to use their voice, that is their option to influence a corporation’s management to focus on shareholder value (cf. Nassauer, 2000, p. 263). An illustrating example are the “Good Governance Guidelines” set up by the California Public Employees’ Retirement System (CalPERS), telling a management how best to enhance shareholder value – hence, institutional investor’s voice differ fundamentally from Deutschland AG’s main bank relationship.

Another expression of the growing role of stock markets and corresponding market actors is the accommodation to U.S. standards in accountancy rules with the introduction of GAAP (U.S. Generally Accepted Accounting Practices) and IAS (International Accounting Standards) – referring to the third aspect in the above list. These accounting rules are “significantly more shareholder-oriented by stressing market valuations and more precise definitions of profits”, while Germany’s traditional accounting rules allow asset valuation at cost rather than market value (Jackson, 2003, pp. 271-272). Since accounting methods according to U.S. standards prioritize the disclosure of profits and losses to shareholders, they accentuate short-termism (cf. Becker, 2001). Institutional investors demand the adoption of Anglo-Saxon accounting rules to allow for cross-country comparisons of corporations (cf. BDI & PWC, 2001, p. 21). By the year 2005 IAS will be compulsory for all 6,700 listed European corporations’ consolidated accounts – a development taking place in the context of the harmonization of Europe’s stock markets within the Single European Market.

A further aspect referring to the reorganization of Corporate Germany is the role of codetermination, that is workers’ participation in corporate decision-making processes in works councils and the supervisory board (for details: Bertelsmann Stiftung & Hans-Böckler-Stiftung, 1998). The disentanglement of Deutschland AG exerts enormous pressure on codetermination, since a marketization of company management and control via the shareholder value principle replaces the stakeholder orientation with its codetermination. Codetermination and shareholder value are opposing ideas by definition:

> “As a criterion of business rationality, shareholder value runs contrary to the participation rights and sharing of organizational rents that characterize nonliberal models. The exclusive focus on shareholders contradicts the egalitarian or solidaristic normative notions of the firm embodied in codetermination or enterprise community.” (Jackson, 2003, p. 285)

Deutschland AG’s system of codetermination had a limiting effect on the scope of shareholder value (see for example O’Sullivan, 2003, pp. 50ff.; Jürgens & Rupp, 2002). But to what extent trade unionists’ systemically entrenched power will endure, is arguable. Obviously strain on the principles of codetermination is increasing with the internationalization of corporate strategies and with ongoing mergers. In the course of this, the German Model's unique negotiating system is being broken up, and the negotiating position of trade unions that are active largely at the national level is weakened. Nevertheless the Association of the German Industry, BDI, laments "the internationally high degree of German codetermination is often an obstacle to investment." (BDI & PWC, 2001, p. 25) The actual power of workers has *de facto* declined due to a "weakening of the operational effectiveness of the system of codetermination", as O'Sullivan (2003, p. 50) concludes. The main reasons are discussed in Fichter's chapter in this book. Going back to the Vodafone-Mannesmann example, the result indicates that "codetermination did not play the role of a *poison pill* to prevent the takeover." (Jürgens & Rupp, 2002, p. 55)

Another aspect referring to the third moment of organization changes is taking place in the composition and bias of many large corporations' management. Traditionally, Germany's industrial management was rather technology-oriented:

> "The somewhat 'de-economized' view which German managers have of the business enterprise is central. The idea that a firm is not a 'money making machine' but a place where products get designed, made and eventually sold, with profits ensuing, tends in Germany to restrict the allure of accountants and financial controllers and to dignify the makers and those associated with them." (Lawrence, 1980, p. 131)

Management careers have been changing, showing in the average tenure, which declined from thirteen years in the 1980s to just six years in the 1990s, and the number of directors with outside work experience, which increased from 17 to 35% (Jackson, 2003, p. 292). With this new internationally trained generation of managers like Detlef Schrempp (DaimlerChrysler) or Jürgen Dormann (Hoechst/Aventis, now at ABB), a "gradual diffusion of an shareholder value paradigm as a new managerial ideology" is noticeable (ibid., pp. 291-292.).

In sum, there are a number of elementary changes in the German Model and Deutschland AG, which can be explained alongside the rise of the phenomenon of shareholder value in the 1990s. Those changes refer to the relationship between banks and industry, its organic long-term perspective, potential for innovation and codetermination providing for a relatively high degree of stability and continuity. National as well as international pressure on the German system of corporate governance altered the parameters between capital and labor in favor of the former. Politically escorted disintermediation and the new centrality on capital markets supported the break-up of the old compromise, shifting corporate focus on short-term results.

7.1. Inherent Risks of Shareholder Value

Despite its popularity with financial operators, the concept of shareholder value is beset with problems. First, the shareholder value system of financial indicators offers only a reductionist perspective that is unable to integrate all dimensions of entrepreneurial value added. In praxis, this leads to a reduction or even stop of necessary expenditures in productive capital that might not instantaneously yield above-average returns, but that might however be essential for maintaining the competitiveness of a company in the longer run, as for example the qualification of employees (Kaplan & Norton, 1996, pp. 22-23). Another critical aspect is the assumed objectivity of those financial indicators. But since the calculation of these indicators is based on premises that lie in the future, any form of objectivity is illusionary.

> "Basically all variables that determine a shareholder value oriented evaluation of the company are dependent on subjective estimates." (Sablowski & Rupp, 2001, p. 60; translation: CK)[14]

After all, the implied microeconomic signification of this management concept is only valid on the assumptions of the theoretic neo-classical assumption of capital market efficiency, which is highly controversial (Sablowski & Rupp, 2001, pp. 47-50; Becker, 2001, pp. 74-84). Premises about stock market movements and their actors' behavior are modeled in laboratory-like surroundings; shareholder value's effect on the actual market value remains a modeled deduction. Moreover, financial market movements and price formation processes of securities are embedded in social micro-contexts and networks on one, and social macro-contexts on the other side. An eventual "success" of increasing shareholder value with recourse to this concept might be more of a self-fulfilling prophecy than of capital market efficiency. There is a high degree of "herd behavior" of investors on financial markets due to standardization of information and benchmark indicators, constantly resulting in "irrational exuberances" on securities markets (cf. Shiller, 2000).

For these very reasons it is not surprising that econometric research could not verify a significant positive correlation between a corporate shareholder value-orientation and enhancement in market value for "converted" German companies (cf. Blies, 2000, pp. 249ff.). This suggests that shareholder value is more of a political instrument for the strengthening of capital owners, but also a means to attract mobile capital in a competition with Anglo-Saxon-type market regimes, so that national actors may initiate market-oriented reforms. Clearly, this current systemic change "reflects changing interests and coalitions among state actors, the investment community, and corporations." (Jackson, 2003, p. 268) The losing faction in this "game" is labor: A survey by PricewaterhouseCoopers (1999) spotted a significant correlation between labor costs and shareholder value. Labor costs are a major factor relative to overall operating costs that have to be focused on the specific value drivers in a second step. In the long run this can result in a decline of the wage level as well as the increased usage of precarious labor contracts (cf. Hirsch-Kreinsen, 1999, pp. 326ff.).

The struggle for shareholder value in Germany is today's class struggle between the capital owners and workers. There are significant alterations in the German model of corporate governance that is at the heart of corporatist Deutschland AG. Two of its special achievements, the social partners' autonomy in matters of wage policy and worker codetermination at plant level and in operations, face widespread pressure for being changed at the expense of workers' influence. Thus, apart from the inherent limitations of the concept of shareholder value, there is a risk of sacrificing the organic stability of the German Model.

8. CONCLUSION: FROM DEUTSCHLAND AG TO "FINANZPLATZ D"

The process of disentangling Deutschland AG has to be interpreted in the context of a number of structural changes during the 1990s: The liberalization of financial markets, the rise of investment banking, stiffer competition at a global scale, to name just a few. Banks, industry, and the Federal Government responded with abandoning the old ways of cooperation among the main stakeholders. The result is a gradual transfer of Anglo-Saxon properties into the German Model, reflecting a general discursive shift towards market solutions away from corporatist approaches.

The key strength of the German Model was its socio-economic stability combined with long-term adaptability and international competitiveness, achieved through a highly integrating power of Germany's institutions, such as codetermination. A major pillar of Deutschland AG was its priority of bank capital to industrial needs, which had a stabilizing and protective effect on Corporate Germany and the economy as whole. In the 1990s, Deutschland AG began to disintegrate in the wake of universal banks' new investment focus, the development of capital markets as sources of corporate finance and the institutional investors' demand for a focus on shareholder value.

The importance of shareholder value and commodification of corporate governance is connected with the neo-liberal notion to improve international competitiveness of businesses and the attractiveness of Germany as a business location for foreign capital investors. However, all institutional and legislative adaptations, which began during Chancellor Kohl's tenure and were continued and deepened by the current Red-Green government, could not lower unemployment or stimulate growth rates. Nevertheless, pressure for the introduction of even more market elements is not likely to cease, since ongoing privatization and liberalization processes enhance the power of institutional investors, which demand continuing reforms of corporate governance. Today, talk about Germany's economic health is no longer about the industrial might of the "Deutschland AG", it is about the "*Finanzplatz Deutschland*" (Financial Center Germany), about creating conditions congenial to finance capital.

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NOTES

[1] The grammalogue AG stands for the German word "Aktiengesellschaft", meaning "incorporated (Inc.)".

[2] The term corporate governance comprises the institutional embeddedness of an economy's main actors (capital, labor and management) and their relation towards each other defined through corporate law, accounting standards, financial regulation, pension schemes, and industrial relations.

[3] A main bank relationship or, as it is also called, relationship lending (Hausbankbeziehung) is definable as a "long-term relationship between a bank and its client firm, the holding of both debt and equity by the bank, and the active intervention of the bank should its client become financially distressed." (Allen & Gale, 2000, p. 103)

[4] Montan-Mitbestimmung, also called "parity codetermination", means that there is an equal number of workers and capital representatives on the supervisory board of a company belonging to the mining or steel and iron industry, Mannesmann's traditional business focus. The "neutral member" in crucial votes could only be appointed with the approval of the union. As Mannesmann moved out of its traditional business during the 1980s, it also moved outside the reach of the law on Montan-Mitbestimmung. A special law, Lex Mannesmann, provided for the continued application of Montan-Mitbestimmung to Mannesmann, but this law was declared unconstitutional by the Federal Constitutional Court in 1999. Thereafter, a weaker version (the codetermination law of 1976) was applied. "Anyhow during the takeover battle Mr. Sigmar Sattler, from the union IG Metall appointed personnel director, was still on the executive board, which indicates that the debate about the Montan-codetermination was rather symbolic." (Höpner & Jackson, 2001, p. 557; translation: CK)

[5] A financial system is viewed as a "set of institutions and organizations at the center of the monetary economy that mediate the flow of savings and investment between nonfinancial sectors of the economy (i.e., the household, nonfinancial company, and state sectors)" (Vitols, 2003a, p. 242).

[6] In 2002, turnover of derivatives in Germany was Euro 111 billion, in 2003 about Euro 145 billion (*source:*http://www.dbresearch.de).

[7] Deutsche Bank is a good example of this trend, since there is a concentration on two main businesses observable, one consisting of corporate finance and investment banking plus trading, the other comprising private clients and asset management.

[8] For example, the investment banks that processed the acquisition of Mannesmann by Vodafone were Goldman Sachs and UBS Warburg (for Vodafone) and Morgan Stanley, Merrill Lynch and JP Morgan (for Mannesmann).

[9] One major national merger was between Bayerische Vereinsbank and Bayerische Hypotheken und Wechselbank in 1998, creating HypoVereinsbank, the second largest bank (Deutsche Bank is the biggest bank in Germany, cf. Bundesverband deutscher Banken, http://www.bdb.de).

[10] A survey by Goldman Sachs estimates that up to Euro 300 billion could flow into the funds of institutional investors as an effect of the pension reform (Goldman Sachs, 2000).

[11] Companies with fewer than 500 employees account for 65% of manufacturing employment in Germany (cf. Vitols, 2003a, p. 245).

[12] For example, the savings banks of Hamburg and Bremen will merge into "Norddeutsche Retailholding" to achieve economies of scale. Frankfurt's savings bank (Frankfurter Sparkasse) wanted to go a similar way (and merge with Naspa in Wiesbaden), but the plan was vetoed by major stakeholders, such as the City of Frankfurt ("Sparkassen in der Zwickmühle", 2003). The savings banks of Hamburg, Bremen and Frankfurt are among the ten largest banks in Germany.

[13] For example, in February 2002 a government commission developed a German Code of Corporate Governance (http://www.corporate-governance-code.de), which follows many private codes of best practice (cf. Jackson, 2003, p. 274).

[14] On the basis of the usage of beta-factors alone (these measure the company-specific risk) a substantial discretionary scope accrues for the underlying capital costs of the invested capital, which is in turn a measurement category for of the discounted cash flow (cf. Taetzner, 2000).

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Chapter 7

KAI MOSEBACH

TRANSFORMING THE WELFARE STATE

Continuity and Change in Social Policy since 1998

1. INTRODUCTION

In 1998, for the first time in German history, a coalition between the Social Democratic Party (SPD) and the Greens (Bündnis90/Die Grünen) came to power. Led by the "triumvirate" of Chancellor Gerhard Schröder (SPD), party leader and finance minister Oskar Lafontaine (SPD), and foreign minister and party leader Joschka Fischer (Bündnis90/Die Grünen), the federal government started to reconcile economic modernization with social justice. However, the resignation of Oskar Lafontaine in spring 1999 and the defeat of Red-Green coalitions in several state elections changed the policy options of the Red-Green administration fundamentally. The Christian Democrats (CDU/CSU) and the Liberals (FDP) now enjoyed a majority of votes in the upper house of parliament (*Bundesrat*). This meant that welfare state reform policies could not be implemented without the approval of the opposition parties and must therefore be concluded through partisan bargaining.

Soon after the Red-Green coalition won the 2002 federal elections, sluggish growth, continued high unemployment and a rising state budget deficit opened the door to criticism. At times resembling public debate in the 1970s, many experts, powerful media organizations and the public identified a governing crisis and the need to update the German Model of welfare capitalism. Particularly, the welfare state and its "social protective agents" should be dismantled to resolve the economic and political crisis (cf. Kitschelt & Streeck, 2003). However, this widely shared interpretation of the state of German welfare capitalism overlooks the dynamic change to the German welfare state that has already begun. The central thesis of this chapter is that the Red-Green federal government is continuing the transformation of the German Model of welfare capitalism (*Modell Deutschland*), which has altered the functional logic of some basic institutions of German welfare capitalism.

The chapter is structured as follows: In section two, I will outline the welfare state implications of the German Model and how it has changed since the economic downturn in the 1970s. In section three, I will describe the central socio-political

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measures initiated during the Red-Green terms of office that affect the main pillars of the social insurance system. I will analyze the reform of the pension and health care systems, employment and labor market policies, especially following the comprehensive *Agenda 2010* of the Red-Green government in its second term in office. Finally, I will summarize the welfare state reform policies since 1998 and discuss their consequences for the German Model.

2. THE GERMAN WELFARE STATE

2.1. Welfare State and Capitalism in Germany: Modell Deutschland Revisited

The German Model is regarded as an example of the simultaneous guarantee of economic prosperity and social justice. Transforming the corporatist legacies of both the Weimar Republic and Nazi Germany, the reconfigured welfare state and the underlying industrial relations became the social foundations of the German Model. A historic political compromise between capital and labor accelerated export-led growth by strengthening the political participation and social integration of trade unions and organized labor. The theory of Fordism tried to explain the success of *Modell Deutschland* after World War II by referring to an institutionalized complex of economic, social and politico-ideological structures (cf. Esser, 1998, pp. 123-125; Kaufmann, 2003, pp. 248-308; see also the introduction as well as Beck's chapter in this book).

The German welfare state safeguards present and former wage earners against most kinds of personal risks. Its volume amounted to 31.8% of gross domestic product (GDP) in 2000. At the heart of the welfare state is social insurance against unemployment, illness, invalidity, occupational injuries, long-term care and old age. In 2000, it accounted for 65.0% of the total social expenditure in Germany (cf. Bundesministerium für Gesundheit und Soziale Sicherung [BMGS], 2003). This social insurance is predominantly public and funded by wage-related contributions. Thus legal immigrants are also entitled to such benefits if they have contributed to these funds for the respectively applicable minimum period of time. The individual social insurance schemes are managed by public bodies. Most of these public bodies consist of representatives of employers and employees, reflecting the fact that professional and status-related boundaries are the most salient criteria of the *conservative* welfare state regime (cf. Esping-Andersen, 1990).[1] Representatives of insured persons are elected through social elections (*Sozialwahlen*), which are traditionally dominated by trade union candidates. Ultimate control rests with the respective federal ministry. Family benefits, civil servant schemes, housing and public assistance complement the benefits of the social insurance system and are funded through state taxes.

Because of the dominance of social insurance aspects within the German welfare state, transformations of labor market structures and production models have direct effects on the financial sustainability of the social insurance system. Rising unemployment and new social forms of employment, for example, low wage, part-time work and precarious employment, have eroded the financial foundations of the wage-related social insurance system (cf. Butterwegge, 2001, pp. 53-56). Consequently, since the economic crisis of the 1970s, there has been an ongoing retrenchment of redistributive measures in every sector of social policy (cf. Steffen, 2003). Despite the lowered levels of individual social benefits, social spending has continued to rise, albeit more slowly (cf. Schmidt, 1998a). Additionally, after reunification the financial burden of the social insurance system rose enormously. Nearly 40% of the total financial transfers to the "new states" was financed by the social insurance system (cf. Bönker & Wollmann, 2000, p. 517). As a result, the share of social expenditure in the GDP increased to 67.7% in 1992 in the new states (cf. Schmidt, 1998a, p. 138).[2]

The conservative-liberal federal government in power from 1982 to 1998 implemented several laws concerning a wide range of socio-political measures (cf. Schmid, 1998; Schmidt, 1998b). Besides several cost-containment policies, three socio-political reforms stood out in particular that introduced structural change into the German welfare state regime. Firstly, *statutory pension insurance* (SPI) was expanded to the new states after reunification in 1992. Beyond that, the Pension Reform Act in 1997 introduced the demographic factor into the pension formula, adapting the indexation of pensions to future life expectancy. The net pension standard should therefore gradually be reduced from 70% to 64% of the net earned income (cf. Lampert & Althammer, 2001, p. 276).[3] Secondly, in 1993, the Christian Democrats together with the opposition Social Democrats concluded the reform of *statutory health insurance* (SHI). They established a kind of managed competition in the German health care system and changed the rules of the game. Since 1997, persons subject to statutory health insurance can choose freely between the sickness funds, thereby overcoming the former professional and regional restrictions of sickness funds (cf. Gerlinger, 2002). Thirdly, parallel to the SHI reform, *long-term-care insurance* (LTCI) was established. Adapting to demographic change and the rising numbers of long-term-care patients as well as aiming at lowering the costs of long-term care for local communities (public assistance schemes), the governing Christian Democrats and the opposition Social Democrats enlarged the pillars of the social insurance system with LTCI. However, the introduction of LTCI also altered the shape and functional logic of the social insurance system. Firstly, in order to finance the new social insurance scheme, a bank holiday was abolished. Secondly, contrary to other social insurances, private providers were explicitly favored over public ones. Thirdly, instead of providing benefits that are universal in nature and distributed in an equitable manner, the LTCI introduced the principle of needs-tested benefits in the social insurance system. Further, the benefits of the LTCI are supplementary to family care and limited to a distinct expenditure level. Therefore, there is a kind of contraction of social insurance benefits within the LTCI (cf. Lessenich, 2003, pp. 211-248).

2.2. European Integration, Post-Fordism and Demographic Change: Challenges to the German Welfare State

European integration has direct and indirect effects on the financing and organization of welfare states as well as the granting of social rights (see also Çağlar's chapter in this book). Firstly, the Stability and Growth Pact imposes a kind of *permanent austerity* on the European welfare states inasmuch as the public deficit consists of the deficits of both the state budget and the social insurance system (cf. Pierson, 2001). Secondly, the project of a Single European Market (SEM) opens the doors to a market for private pension and private health care insurance (cf. Beckmann, 2003; Mossialos & Thomson, 2002). Furthermore, the SEM has had some serious repercussions for national welfare state regimes. The four basic freedoms afforded by the SEM (freedom of goods, services, capital and labor) challenge welfare states and social policies across Europe (cf. Aust et al., 2002; Leibfried, 2000). Because of several rulings by the European Court of Justice, public services crossing national boundaries are in principle also subject to European law. Concerning health services, for example, national regulations must not prevent the trade of health services in Europe. The limitation of the four freedoms is acceptable only in cases where the financial foundations of social security systems would be undermined. Additionally, European competition law limits the opportunities of financial subsidization of public services to very narrowly defined conditions (cf. McKee et al., 2002; Busse et al., 2002). Thirdly, from the start of European integration, directives, regulations and European policy coordination have affected national social policy, even health care policy. So far, however, the socio-political competencies of the European Union remain limited (cf. Leibfried & Pierson, 1998). In 2000, the European Union started its Lisbon Strategy, which should make Europe the most productive and competitive region in the world by 2010. This comprehensive policy project gave birth to the German Agenda 2010 during the second Red-Green term of office. The Agenda 2010 aims at fundamentally transforming the German welfare state (cf. Bundesregierung, 2003).

The post-Fordist transformation of capitalism introduced a new production model resulting from globalizing management strategies that alter the shape of industrial relations. The transformation of the workforce in post-Fordist times could be accounted for by the new politics of managerialism (flexibility, outsourcing and subcontracting) (cf. Dörre, 2001; see Fichter and Klobes' chapter in this book). Moreover, industrial change, technological innovations and the obsession of international competitiveness strengthened the tendency toward mass unemployment (see Beck's chapter in this book). The management and politics of flexibility brought about more precarious and informal forms of employment, working poor and higher income inequality. In effect, the model of the *male-bread-winner family* has been eroding, thereby undermining the foundations of the Fordist welfare state (cf. Altvater & Mahnkopf, 1999, pp. 317-363; Altvater & Mahnkopf, 2002, pp. 84-163).

Finally, the demographic change in industrialized countries is seen as a threat for the financial sustainability of the social security system in the future. International organizations such as the World Bank (1994) or the Organization for Economic

Cooperation and Development (OECD) (1988) have already pointed to this development and made clear early on that a transformation of the welfare state was necessary (cf. Pierson, 1998, p. 169). The consequences of the demographic change are, however, highly variable depending on the social risk that should be insured. Therefore, the predictable impact of demographic change on the welfare state is less clear than the simple fact that there has been a continuous process of demographic change in all modern societies since industrialization. The reason for the difficulty in assessing its impact is that many other factors such as productivity growth, labor market trends, migration and the number of persons in work modify demographic effects on both pension and health insurance schemes (cf. Ganßmann, 2001, pp. 132-134; Kühn, 2004).

3. WELFARE STATE REFORM POLICIES SINCE 1998

During its first term in office, the Red-Green coalition acknowledged that the three main pillars of the German welfare state (pension, health care and labor market policy) were still in a state of crisis. At first, the government aimed at increasing the benefits for some recipient groups and to close some gaps in the welfare provision within the generally accepted framework of tight budgets (SPD & Bündnis90/Die Grünen, 1998). After the resignation of finance minister and party leader Oskar Lafontaine (SPD) in spring 1999, and especially after its reelection, the coalition’s primary objective shifted toward limiting welfare benefits in order to trim social expenditures and to relieve the industry of ever-increasing social contributions. In its second term, the Red-Green government started a comprehensive policy program, the Agenda 2010, which should adapt the welfare state to demographic changes, enhance the international competitiveness of German enterprises, and revive economic prosperity (cf. Bundesregierung, 2003, pp. 4-5).

In this section, I will focus on the reform policies after 2000 that have restructured the most important and interrelated social insurance schemes (pension, health care and unemployment). In chronological order, I will start with the reform of the statutory pension insurance in 2001, then focus on the measures relating to the statutory health insurance, and finally sketch out the recent labor market and employment policies in Germany as initiated by the Agenda 2010.

3.1. Pension Policy: Implementing Paradigm Shift(s)

3.1.1. Confronting Demographic Change through Private Funding

The Red-Green pension reform was put into force by two laws after intensive consultations with the opposition parties that held the majority in the *Bundesrat* in 2001 (*Altersvermögens-* and *Altersvermögensergänzungsgesetz*). The reform changed the structure and logic of statutory pension insurance fundamentally.

The central aim of the Red-Green pension reform was to limit the contributory rate in 2030 to a maximum of 22% of wage earner’s income. Without a reform, owing to demographic change, the contribution rate of the public pension scheme was expected to rise from 20.3% in 1998 to a maximum of 27.9% in 2030 (Mosebach, 2002, pp. 136-137). This was seen to be financially unsustainable and to undermine the international competitiveness of the German economy. Consequently, the net pension standard had to be lowered from 69.1% in 2001 to 67.9% of the average net earned income in 2030 (cf. Döring, 2002, p. 105). Firstly, the pension reform lowered increases in pension by altering the formula for indexation of pension. The implementation of the Agenda 2010 led to further changes in the pension formula and to the postponement of the annual indexation in 2004. Secondly, the government changed the method of calculation of the net pension standard. Measured against the old calculation method, this change amounted to a reduction of the net pension standard to 64.3% instead of 67.9% in 2030 (cf. Steffen, 2003, pp. 39-41). Additionally, the level of the minimum pension will reach 46% in 2020 and 43% of the net earned income in 2030, respectively, but is essentially dependent on social insurance contributions being made during working life. If not compensated by additional private pension funds, the new system of the statutory pension insurance would produce high levels of old-age poor in the future (cf. Arbeitsgruppe Alternative Wirtschaftspolitik [AAW], 2004, pp. 93-98; Deutscher Bundestag, 2004).

Therefore, the most salient reform measure was the creation of a state-subsidized, additional private pension scheme (*Riester-Rente*). This is a paradigm shift in German pension policy because the standard of living for pensioners will now depend on both the limited public pension scheme and the additional private pension insurance. In effect, the additional private pension insurance also should promote Germany's financial industry (see Kellermann's chapter in this book).

The reform's goal is to ensure an adequate standard of living for pensioners in 2030, combining public and private pension schemes. Moreover, because of the pension formula, the calculated private pension capital yield should compensate for the gradually decreasing net pension standard. However, the additional private pension scheme is voluntary, although there are some critics that would prefer a statutory private pension scheme. The financial products that could be used for this subsidized additional private pension scheme have to be approved by a federal body through public certificates. In reaction to criticism by trade unions, the law also allowed the introduction of occupational pension funds. In order to support the initial spreading of the additional private pension scheme, it is tax-subsidized and not subject to social contributions until 2009. Therefore, social insurance revenues will be reduced during that period, enlarging the financial deficits of the social insurance system. Nevertheless, the additional private pension scheme also requires that entitled persons have personal income at their disposal (cf. Nullmeier, 2003; Döring, 2002, pp. 100-121).

3.1.2. Adapting to the New Workforce: Basic Pension and Extending Entitlement

The Fordist welfare state was based on the normative model of the *male-bread-winner family* during an era of full employment. The post-Fordist transformation of the labor market has altered the shape of the working society. Mass unemployment, longer periods of training, unstable working life and new social forms of waged work reduce both the revenues of the social insurances and the entitlements of the employed population to old-age pension and hence a secure standard of living (cf. Nickel, 2000; Döring, 2002, pp. 53-63).

Contrary to this trend, the number of women in remunerative occupation has risen steadily since the 1970s. It reached 18.0 million women in 2002 from 9.5 million in 1970. Thanks to the high employment rate of women in the former German Democratic Republic, the number of women in remunerative occupation jumped about 4 million after reunification. As a consequence, the number of employees liable to social insurance contributions increased. However, this increasing number is mainly accounted for by part-time jobs, thereby linking the higher employment rate of women to the post-Fordist transformation of the workforce (cf. AAW, 2003, pp. 197-210; Altvater & Mahnkopf, 2002, pp. 121-134; BMGS, 2003, Tables 2.3-2.6A).

In its first term in office, the Red-Green federal government tried to meet these challenges with two reform measures. Firstly, it introduced an income-tested basic pension that should prevent pensioners from becoming poor because of too few contributions to the statutory pension insurance. Retired persons were promised an income-tested basic pension of 15% above social security benefits (Auth 2002a, pp. 292-293). Contrary to the aim of the Red-Green government, this basic safeguard has not been integrated into the system of the statutory pension insurance but into the public assistance system financed by taxation. However, the basic pension is granted only in cases of neediness and therefore must not be confused with a minimum pension such as that found in Switzerland and the Netherlands (cf. Döring, 2002, pp. 107,111). Since it was integrated into the system of public assistance, the basic pension does not change statutory pension insurance in principle. Nevertheless, the reform shows that the statutory pension insurance no longer suffices for ensuring the standard of living in old age and is only part of a more comprehensive social protection system for old age (cf. Nullmeier, 2003).

Secondly, the Red-Green federal government extended the liability to pay social insurance contributions to “seemingly” self-employed persons (*Scheinselbständige*) and “insignificant” employed persons (*geringfügig Beschäftigte*). The phenomenon of the seemingly self-employed could be accounted for by outsourcing and subcontracting methods of business reengineering. Employees became self-employed persons who did not pay social insurance taxes. The Red-Green government wanted to change this because it undermined the financial foundations of the social insurance system. It therefore passed a law that tried to distinguish between the “truly” self-employed, who are not liable to mandatory insurance, and seemingly self-employed persons (*Gesetz zu Korrekturen in der Sozialversicherung und zur Sicherung der Arbeitnehmerrechte*). The seemingly self-employed were required to contribute to social insurance. In response to pressures from corporate interest groups, the criteria for determining seeming self-employment were relaxed in 2000 (Auth, 2002a, pp. 287-289). Soon after reelection, the Red-Green coalition scrapped this distinction altogether. Implementing new labor market regulations, the concept of the *Ich AG* (*Me Inc.*) became a substitute for seemingly self-employed persons in 2003 (see the section about labor market policy in this chapter). Under this program, people receive a state subsidy if they give up their unemployed status to become self-employed; they are also liable to social insurance contributions (cf. Steffen, 2004, p. 27).

In an effort to increase the base for social security contributions, the Red-Green government initially subjected employers of insignificantly employed persons to social insurance contributions. Instead of the flat-rate income taxation of 20%, the Red-Green coalition decided in 1998 that social insurance contributions for remunerative occupations with a net income lower than 325 euros should be paid by the employer. The contributory rate for the statutory health insurance is 10%, for the statutory pension insurance 12%, of the gross income. To get full pension entitlement, employees could increase their employer's social insurance contribution voluntarily. In 2000, only 140,000 of the four million insignificantly employed persons did this (Auth, 2002a, pp. 289-290). Again, the newest labor market regulations changed the rules of the game. Since 2003, the income level for insignificantly employed persons has risen to 400 euros. From 400 to 800 euros, the social insurance contributions of the employee increase gradually to the level of full liability to pay social insurance contributions (cf. Steffen, 2004, p. 27; see Section 3.3. of this chapter). In effect, the volume of low-wage earners will probably grow larger. Possible positive effects of the liability to pay social insurance contributions will depend on whether the insignificantly employed are included additionally in the social insurance system or whether lower paid employees are substituted for full-time working and high-wage employees. If the former replace the latter, the revenue losses of the social insurance system may lie above its additional revenues. Further, an expansion of the insignificantly employed also reduces the annual average gross income, which is used for the calculation of pensions. Both effects also apply to the expansion of part-time jobs under the aforementioned conditions (cf. Nickel, 2000).

3.1.3. Promoting Families: Between Women Empowerment and Neo-Patriarchy

The old-age provisions for women often depend on the old-age pension of the male bread winner. Forced by a ruling of the German Federal Constitutional Court that working parents must not be put at a disadvantage compared to working people without children, the Red-Green coalition introduced an independent old-age pension for child-caring women (and men). After 25 years of liability to the statutory pension insurance (SPI), a parent's working income during the first ten years of life of the child(ren) would be increased by 50% to a maximum of 100% of the average net earned income of the SPI-insured persons. The entitlement to old-age pension would thereby still depend on remunerative occupation (cf. Auth, 2002a, pp. 294-296).

From a gender perspective, the implemented measures improved the situation of child-raising and working women (and men) but failed to address the structural disadvantages to women concerning wage income and labor market power. Firstly, the limitation of the upgrading to the first ten years of life supposes that after ten years the labor market discrimination of women would disappear. Because labor market discrimination against women is still a reality and an adequate system of child care is still lacking, this regulation is insufficient. Secondly, the current labor market trends toward low-wage labor affect mainly women. Therefore, the independent old-age pension for women could be undermined by general developments of the workforce and labor market policy (cf. Auth, 2002b, pp. 238-239; AAW, 2003, pp. 197-210; Altvater & Mahnkopf, 2002, pp. 121-132).

3.2. Health Care Policy: Between Competitive Corporatism and Patient Empowerment

During the campaigns for the 1998 federal parliamentary election, health care policy played an important role in distinguishing the old governmental coalition of Christian Democrats and Liberals from the Social Democrats and the Greens. The Social Democrats criticized the introduction of several competition-led instruments into the German health care system by the former government. The Red-Green government also highlighted its desire to restructure the health care system in order to make the health care service provision more effective and efficient (cf. SPD & Bündnis90/Die Grünen, 1998). There was also a broad partisan consensus that the restructuring of health care financing and provision should not undermine the international competitiveness of the German economy. Especially after the economic slowdown in 2001, the public has been concerned about rising ancillary wage costs that could threaten the German economy.

Although the opposition Christian Democrats and Liberals had veto power in the *Bundesrat*, the recent health care reform act (*GKV-Modernisierungsgesetz*) introduced several structural changes into the German health care system in 2004. Firstly, a health care financing reform aimed at containing costs to prevent social insurance contributions from rising and overcoming some difficulties of the already implemented system of managed competition between the sickness funds. Secondly, the provision of health care services was restructured, strengthening the move toward managed care. Thirdly, the role of patients and patients' advocacy organizations in the corporatist bodies of the German health care system were empowered both to democratize and legitimize the decision-making processes and enable the patient to act as a rational consumer of health services.

3.2.1. Health Care Financing: Back to the Future

From a welfare state perspective, the German health care system serves as the model for the social insurance-based health care systems across Europe (cf. Rosenbrock & Gerlinger, 2004, pp. 31-38). However, after a decade of intensive comparative policy research and cross-border policy transfer, the boundaries of the underlying ideals are blurring (cf. Mossialos & Dixon, 2002). Nevertheless, focusing on the issue of health care financing, the German health care system is still unique with its double structure of statutory health insurance (SHI) and substitutive private voluntary health insurance (VHI). In 1999, 88.5% of the German population was insured through the SHI. The health care expenditures of the SHI are mainly financed through income-related social insurance contributions (by employees and employers), although there is some cross-subsidization through the pension insurance scheme for the SHI of pensioners, the unemployment insurance, and the responsible bodies of the public assistance schemes (cf. Rosenbrock & Gerlinger, 2004, pp. 89-94). In 1993, a broad coalition of Social Democrats and Christian Democrats introduced elements of managed competition into the German health care system, establishing a kind of paradigm shift (cf. Gerlinger, 2002). Since 1997, SHI-insured persons can choose from among the sickness funds. There are several pooling instruments in place to prevent sickness funds from *cream-skimming* for healthy, wealthy and young insured persons. The risk adjustment mechanism (*Risikostrukturausgleich*) provides a kind of redistribution of incomes among the different sickness funds. Its functioning should be improved by 2007 (cf. Rosenbrock & Gerlinger, 2004, pp. 237-241).

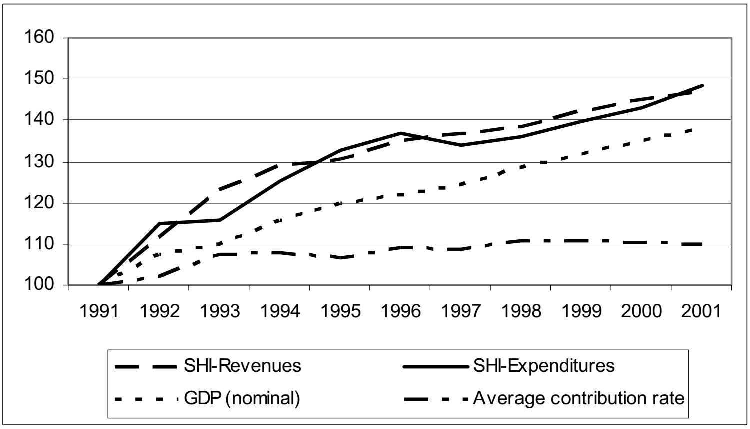

Figure 1: SHI revenues and SHI expenditures compared to GDP and average contribution rate to SHI (1991 = 100)

As in comparable countries, the main problem concerning health care financing in Germany is rising social insurance contributions. Therefore, the Agenda 2010 has the political goal of reducing health insurance contributions in order to save the international competitiveness of the German economy while adapting to future challenges that might lead to higher health care expenditures (cf. Bundesregierung, 2003, pp. 34-37). There has been a remarkable stability in overall health care expenditures (measured against their share in GDP) for SHI since the 1970s, such that the average health insurance contribution rate rose only slightly from 12.4% in 1991 to 14.0% of wage earner’s income in 2002 (Bundesministerium für Gesundheit, 2002, Table 10.11). Despite public concerns about the costs of demographic change, new medical technologies and rising demands by health service consumers, this increasing health insurance contribution rate could be explained mainly by the reunification process as well as by the stagnation of assessable incomes, mass unemployment and new social forms of labor (cf. Kühn, 2001; AAW, 2002, pp. 129-131; see Figure 1.). Moreover, as there are competing theoretical models about relevant cost-driving factors, the effect of demographic change and innovative technology on rising health care spending is debatable. Until now, there has been no evidence of a serious cost-driving dynamic of demographic change or of medical technology (cf. Kühn, 2004; Mosebach, 2002, pp. 140-147; Braun et al., 1998).

After rescinding some privatization measures of the former government, the Red-Green coalition tried to introduce both a general budget to limit the overall expenditures of the SHI and a monistic financial system for the hospital sector. However, both attempts failed because the *Bundesrat* did not approve these regulations (cf. Hartmann, 2003, pp. 264-265). In 2002, the Red-Green government established a governmental commission to work out the foundations for a sustainable health care financing reform that would appropriately address future challenges, especially demographic change and globalization (Kommission für Nachhaltigkeit in der Finanzierung der Sozialen Sicherungssysteme [Nachhaltigkeits-Kommission], 2003). However, beyond some cost-containment measures, this commission did not reach a consensus as to how to reform health care financing. There are two competing concepts for a structural reform of health care financing. Firstly, there is a proposal to integrate statutory health insurance and private voluntary health insurance as well as to make some forms of capital income liable to health insurance contributions. This *citizens' health insurance* (*Bürgerversicherung*) would be based on the solidarity principle and thereby extend the assessable incomes of the (enlarged) statutory health insurance. Secondly, a flat-rate *capitation premium* (*Kopfpauschale*) is offered that would end the solidarity principle in the German health care insurance. It would be complemented by a needs-tested financial state subsidy for poor private households. Both concepts are still under debate, but it is obvious that they would alter the shape of health care financing in Germany radically (cf. Neubacher, 2004).

After its surprising victory in the September 2002 election, the Red-Green government prepared a comprehensive health care reform act. But because of the veto power of the Christian Democrats and Liberals in the *Bundesrat,* the government chose a broad coalition together with the Christian Democrats to conclude a law to modernize the statutory health insurance (*GKV-Modernisierungsgesetz*) in autumn 2003. As a kind of concession, the opposition parties expected from the Red-Green governmental coalition to withdraw the juridical obligation to establish a so-called "positive list" for the reimbursement of pharmaceuticals (cf. Schwartz & Mosebach, 2003). Because of the competing partisan concepts about health care financing reform, the respective law focused mainly on restructuring the system of health care provision. The only measures affecting health care financing directly were the introduction of a new system of co-payments, the exclusion of dentures and non-prescription drugs from the benefit package, and the privatization of sick-pay financing. Further, it introduced some instruments that should prevent persons voluntarily insured under the statutory health insurance from changing to the private voluntary health insurance (cf. Orlowski & Wasem, 2003, pp. 13-30). However, the higher level of co-payments together with the redefinition of the hardship clause gave rise to concerns that the solidarity principle would be undermined (cf. Pfaff et al., 2003).

3.2.2. Health Care Provision: Toward Managed Care and Patient's Empowerment

Contrary to other parts of the German welfare state, health care is generally characterized by a high intensity of service provision. The German health care system consists of a triangle of patients and insured persons, health care financers and health care providers. The health care providers are either state-owned, private non-profit or private for-profit enterprises. In the case of SHI-accredited physicians, they are also independent professionals. The German health care system is structurally fragmented into the ambulatory sector and the hospital sector, respectively. The remuneration of health care providers is maintained through negotiations between sickness funds and health care providers on the state level (cf. Rosenbrock & Gerlinger, 2004). The implementation of laws and regulations in the German Model of health care depend heavily on the actions and knowledge of both health care financers and health care providers. Moreover, the laws concerning the reimbursement of health care through the statutory health insurance and the regulation of health care provision will be implemented by a public body referred to as the Federal Committee of Physicians, Sickness Funds and Hospitals and consisting of the representatives of the respective actors (cf. Niebuhr et al., 2003; Urban, 2001). Therefore, the German health care system is often referred to as a corporatist system in the "shadow of hierarchy", that is being supervised by the state. In political terms, there are three levels of actors: The federal government, the states and the public bodies of health care financers and health care providers. The number of potential *veto players* in health care policy multiplies and makes policy change much more difficult (cf. Rosenbrock & Gerlinger, 2004, pp. 13-22).

In 2003, the Red-Green government together with the Christian Democrats introduced new instruments of managed care into the health care system. Although the SHI Modernization Act differed in some respects from the original draft of the Social Democrats and Greens (cf. Schwartz & Mosebach, 2003), the regulations of health care service provision changed. The idea of managed care is, firstly, to integrate both health care financing and health care provision. Its goal is to reduce the costs of health care provision through several management instruments. Secondly, managed care aims to integrate health care provision along the different stages of health intervention (prevention, cure, care, rehabilitation). In that case, it is also often referred to as "integrated delivery systems" (cf. Amelung & Schumacher, 2004). While the move toward integrated care had already started in 1997, the Red-Green government strengthened the opportunities for sickness funds to have selected contracts with health service providers, especially to provide integrated care for the chronically ill ("disease management"; cf. Rosenbrock & Gerlinger, 2004, pp. 239-241). Also, the *Gesundheitsreformgesetz 2000* for the first time enabled cooperation between ambulatory and hospital sector service providers. But there was no evidence of a dynamic expansion of these models of integrated care after the implementation of the underlying law (cf. Gerlinger, 2003, pp. 376-380; Mosebach, 2003, pp. 422-424). Consequently, in 2003 the recent health care reform act introduced economic incentives to develop models of integrated care further (cf. Orlowski & Wasem, 2003, pp. 69-76).

The *GKV-Modernisierungsgesetz* also strengthened patients' rights. It established on the one hand patient representatives in the corporatist bodies of the German health care system, especially in the Federal Committee of Physicians, Sickness Funds and Hospitals. Although the patient representatives have no voting power, their presence is indeed a cultural change in German health care policy. On the other hand, the modernization act founded the governmental office of "Patient Ombudswoman", which should respond to complaints and questions of patients and insured persons as well as work as an advocate of patients' interests and rights throughout (legislative) processes in the political system (laws, regulations, etc.) (cf. Mosebach, forthcoming for a detailed analysis). It is too early to assess the impact of the strengthened patient participation in the German health care system. But there is no doubt that it should introduce some countervailing power into the corporatist bodies, formerly dominated by health care financers and health care providers.

3.3. Employment and Labor Market Policy: From Welfare to Workfare

The creation of jobs was the main policy priority of the Social Democrats during the election campaigns in 1998. Indeed, the Red-Green government set the goal of reducing unemployment from 4.2 million in 1998 to 3.5 million in 2002 (cf. Blancke & Schmid 2003, p. 218). After the election, the new Red-Green government started revoking some labor market measures that the former conservative-liberal coalition had implemented. Both the reduction of continued wage payments during the first six weeks of sickness and the regulation of dismissal protection were repealed. The next step was the revival of the tripartite employment pact that had failed under Chancellor Kohl in 1996. It was called the Pact for Work, Innovation and Social Justice and consisted of representatives of the government, trade unions and employers' associations. Although a number of academic papers were produced (cf. Eichhorst et al., 2001) and two pilot schemes concerning regional labor market regulation were promoted (cf. Blancke & Schmid, 2003, p. 219), the pact failed in 2001 because of conflicting views between trade unions and employers' associations about employment policy (cf. Heinze, 2003). Therefore, it took nearly two years before the Ministry of Work and Social Security proposed its own strategy to make the labor market policy more efficient (cf. Blancke & Schmid, 2003, pp. 219-220). Starting with the *Job-AQTIV-Gesetz,* the new government was going to change the face of labor market policy, putting more weight now on *preventive measures*.

Just before the 2002 election and in reaction to the rising unemployment rate, the government appointed a policy advisory committee of experts led by Peter Hartz, human resources manager of Volkswagen, to reform the institutional setting of labor market policy in Germany, primarily the Federal Employment Office (Kommission für Moderne Dienstleistungen am Arbeitsmarkt [Arbeitsmarkt-Kommission], 2002). From 2002 to 2004, the Hartz Laws I-IV put into force some of the commission's proposals. Labor market policy members of the tripartite employment pact shared with many other expert committees the view that only (partly subsidized) low-wage labor could overcome the service gap of the German economy and create new jobs (cf. Eichhorst et al., 2001).

3.3.1. Employability, Entrepreneurship and Workfare: Toward Activating Labor Market Policy

From 1991 to 2003, the number of unemployed persons rose from 2.6 million to 4.4 million. Accordingly, the unemployment rate went up from 7.3% (1991) to 11.6% (2003). The unemployment situation in the new eastern states is worse. After reunification, the unemployment rate jumped immediately to 11.9% (1.0 million) in 1991 and had risen to 20.1% (1.6 million) in 2003. Further, there are a large number of people who have been unemployed for longer than a year ("long-time unemployed"). The proportion of long-time unemployed in the total number of unemployed rose from 17.5% in 1991 to 31.6% in 2003. After a decline from 1997 to 2001, unemployment again rose in both western and eastern Germany (see Figure 2.). Beyond that, 2003 saw an employment gap of nearly 8 million workplaces (up from 5.4 million in 1991), adding together the officially unemployed with people taking part in labor market policy schemes and people who would like to work but neither receive unemployment benefits nor are engaged in labor market policy activities. The overall employment gap declined shortly after it had reached a peak in 1997. Since 2000, it has begun to rise again (AAW, 2004, p. 277).

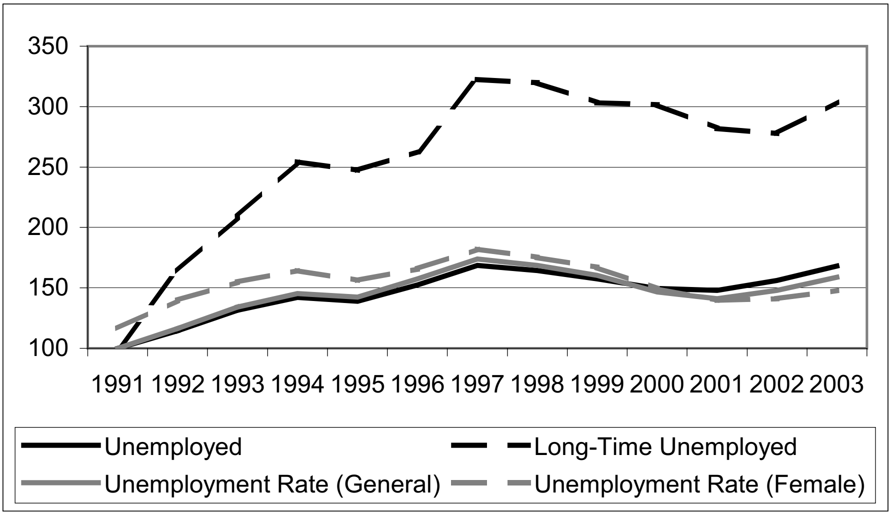

Figure 2: Indices of unemployment in Germany from 1991 to 2003

The Hartz Laws I-IV are supposed to reverse this trend. While it is far from certain that they will achieve this objective, they will alter the shape of German labor market policy fundamentally (cf. Steffen, 2004, pp. 26-29; Wagner & Schuldt, 2003).

Firstly, the level of unemployment benefits and unemployment aid was lowered several times and the criteria for accepting job offers were strengthened. Both concepts aimed at motivating unemployed persons to apply for a job, presuming that limited engagement of the unemployed and too generous unemployment benefits prevent the unemployed from seeking jobs (cf. Wagner & Schuldt, 2003, pp. 39-41). In 2005, unemployment aid and public assistance will be integrated in order to make work incentives stronger for the long-term unemployed. The integration will also overcome the contradictory relation between the financial sources of unemployment aid (federal level) and public assistance (municipalities and towns). This division has led many unemployed to be transferred from one public body to the other and vice versa so that the respective body can avoid paying social transfer income. There is wide consensus that the fusion could make the interaction between unemployment aid and public assistance more effective and efficient. But the law focuses mainly on further reducing the level of unemployment aid and public assistance. The income level of the former will be reduced to approximately that of the latter, thereby leading to a serious income loss for the long-term unemployed (cf. Tripp & Bruhn-Tripp, 2004).

Secondly, many local job centers have established *Personal-Service-Agenturen* (PSA), which should foster subcontracted employment in order to make finding a job more efficient and in line with market demand. The *Arbeitsmarkt-Kommission* placed the PSA in the middle of its reform concept because it is embedded in the restructuring of the Federal Employment Office and its local job centers (*Arbeitsmarkt-Kommission*, 2002, pp. 147-157). PSAs offer subcontracted employees to private employers on a time-limited basis and at a lower wage level, allowing employers to avoid unlimited employment relationships. The employment effects of PSA were rather low in 2003; 750 PSAs placed only 50,000 subcontracted employees. In general, the employment effect of subcontracting depends also on overall economic performance. Further, there is the problem that PSA subcontracting might lead to the substitution of full-time employees with subcontracting employees due to the limited wage costs associated with the latter. Moreover, the for-profit nature of the PSA could promote cream-skimming from among the unemployed, thereby undermining the PSA's original aim to overcome the fragmented labor market structure and avoid the contradiction of labor market insiders and outsiders (cf. Wagner & Schuldt, 2003, pp. 46-54).

Thirdly, in 2003, "mini- and midi-jobs" were created to enable a low-wage labor service sector. They replace the 1999 regulation of insignificantly employed persons. The remuneration limit rose from 325 to 400 euros. Between 400 and 800 euros, only limited social insurance contributions (health and pension insurance) have to be paid. The social insurance liability would not apply in cases where one mini-job supplements a job that is already subject to social insurance contributions. In effect, the income spread of insignificantly employed persons is enlarged up to 800 euros. Further, instead of limiting the working time of the insignificantly employed to 15 hours as in the old regulation, this restriction is withdrawn. Now there is no working time limit, thereby creating the incentive to increase the working time by lowering the hourly wage (cf. Wagner & Schuldt, 2003, pp. 54-68).

Finally, the *Ich AG* ("Me Inc.") tried to overcome mass unemployment by developing a new sense of self-employment. Unemployed persons that decide to set up an enterprise or work self-employed would be financially supported by the state for the first few years of self-employment. The employment effect of the *Ich AG* is probably very modest, but a serious assessment can only be made in a few years (cf. Wagner & Schuldt, 2003, pp. 68-78).

3.3.2. Service Gap and Low Wage Labor: The Limits of Employment Policy

Besides the preventive and workfare turn of labor market policy, employment policy in Germany also changed dramatically during the 1990s. Since the establishment of the Benchmarking Group of the tripartite *Bündnis für Arbeit,* the main reason for unemployment in Germany has been seen in the general wage level being too high for less productive services (for the Benchmarking Group, see Mosebach, 2002, pp. 147-151). Therefore, the promotion of low-wage labor would create more jobs. Also the Hartz Laws have introduced some measures that aim at boosting the number of low-wage jobs in Germany. Firstly, the introduction of mini- and midi-jobs should bring about new jobs in the low-productivity service sector. Secondly, the fusion of unemployment aid and public assistance also should motivate the unemployed to apply for low-wage labor jobs. Both measures presume that lower wage levels would create more jobs. This assumption has to be questioned, however. There are serious theoretical arguments and empirical evidence against this neo-classical point of view (for a theoretical assessment, see Beck's chapter in this book).

Empirical evidence shows that the job creation dynamic of the mini- and midi-jobs has been rather low. As a consequence of the new regulation of insignificantly employed persons, about 0.75 million mini-jobs are no longer liable to social insurance contributions. The same holds for midi-jobs insofar as 1.1 million jobs between 400 and 800 euros will partly reduce their social insurance liabilities. The conclusion is that mini- and midi-jobs have been created mostly out of full-time or at least part-time jobs. In effect, the social insurance revenues would probably diminish, thereby accelerating the financial deficits of the social insurance system. Recent estimates conclude that there was a loss of social insurance revenues of about 612 million euros in 2003 (cf. Rudolph, 2003).

Secondly, the fusion of unemployment aid and public assistance will start in 2005. The level of unemployment aid will be near to that of public assistance in the future. Therefore, unemployed persons have a very strong incentive to accept any kind of work offered them. It will be up to the municipalities and towns to create new jobs. Only the future will show whether the fusion of both social security instruments will limit their underlying institutional contradictions. However, if the problem of unemployment is rooted in the loss of an adequate number of jobs, then the lower level of unemployment aid will at best create new forms of working poor that might worsen the problems of the German economy by reducing the domestic demand of private households. Further, there is still political unrest accompanying the implementation of that fusion, putting the SPD on the brink of splitting (cf. AAW, 2004, pp. 186-190; Koch & Bäcker, 2003; Berg et al., 2004; Bönisch et al., 2004).

4. CONCLUSION: TOWARD A NEW GERMAN WELFARE STATE?

The social insurance-based German welfare state depends heavily on the number of employed people. Accordingly, welfare state reform policies are embedded in more general concepts of economic policy. According to neo-classical economics, dominating in policy advising and partisan politics since years, the phenomenon of mass unemployment has to be tackled essentially on the labor market. Consequently, the widely shared conceptual link between economic policy and welfare state restructuring is to prevent the ancillary wage costs (i.e. the social insurance contributions) from rising, which could undermine efforts to reach higher levels of economic growth. In effect, beyond the formal continuity of basic institutions, this policy has initiated a process of welfare state transformation in Germany. Also the Red-Green coalition and especially the Agenda 2010 followed that road of social policy reform by introducing comprehensive measures to restructure the German welfare state.

Firstly, the establishment of state-subsidized, additional private pension funds was a paradigm shift in pension policy because the statutory pension insurance (SPI) would no longer be able to safeguard the standard of living for old-age pensioners. The most important aim now was to limit the SPI contribution rate to a maximum of 22% of wage earner's income in 2030. From a normative perspective, the standard of living could only be guaranteed through a comprehensive system of old-age provisions, integrating SPI, private funding and a minimum pension. But because of the high level of unemployment, new forms of labor and the politics of low-wage labor, many people will face poverty at old age. Therefore, the Red-Green coalition succeeded in introducing an additional private pension scheme but failed to guarantee the standard of living to every old-aged employee. Beyond this paradigm shift, the Red-Green coalition tried to adapt the SPI to the changing workforce and to enhance the independent old-age pension for child-caring parents, especially women by extending the pension entitlements and liability to pension insurance contributions.

Secondly, related to the political stalemate between the Red-Green government and the opposition parties in the *Bundestag* (lower house of parliament) and the *Bundesrat* since spring 1999, health care policy has been torn between a paradigm shift in health care service provision and a continuation of the health care financing reforms of the late 1990s, thereby reflecting the widely overlapping but in some respects different concepts of health care reform of the (governing) Social Democrats and (opposition) Christian Democrats (cf. Gerlinger & Stegmüller, 1995; Bandelow, 1998). In 1998, the Red-Green government started repealing the privatization measures of the former federal government. As economic growth declined and social insurance revenues fell as a consequence, the question of health care financing made a comeback in 2001. But unlike health care provision, the subject of health care financing is highly disputed between governing and opposition parties. From the perspective of social security, the governmental coalition has not yet introduced any structural changes within the statutory health insurance (SHI). Because a structural change to the financial foundations of the German health care system is still at stake and unresolved, the economic crisis and rising social insurance contributions have led to an introduction of a higher level of co-payments in Germany, ironically undermining the initial efforts of the Red-Green governmental coalition to balance universal access to health services and international competitiveness by withdrawing some privatization measures of the former government. The introduction of privatization measures and higher co-payments through the recent health care reform act contradict the solidarity principle of the SHI. However, in historical terms, it does not constitute a structural change in welfare state policy because it is essentially a return to some policy instruments of the former conservative-liberal government. The path change in health care was introduced with the *Gesundheitsstrukturgesetz* in 1993, implementing managed competition in the German health care system. Regarding the reform of health care service provision and the strengthening of patient rights, the conclusion might be different. These are in fact structural changes but the effects of these measures still remain to be seen. The next paradigm shift in German social policy will probably be the upcoming health care financing reform, be that the citizen insurance or the capitation premium. Both would alter the shape of the statutory health insurance fundamentally, by either enlarging or undermining the solidarity aspects of the statutory health insurance.

Nevertheless, as the analyses of the pension and health care reform policy have shown, the German welfare state will still depend on labor market developments in the future. Therefore, it is necessary to revive the economy and create new jobs that would be liable to the social insurance system. But the current labor market and employment policy of the Red-Green government seems to be unable to overcome the situation of mass unemployment. To the contrary, neither the macroeconomic policy nor the newest labor market regulations will likely create a huge number of new jobs. Further, the new labor market policy will reduce the social insurance revenues and accordingly put the financial stability of the social insurance system at risk. Despite the widely shared view that the German welfare state had to be made more efficient and flexible by dismantling the social protective agents, we can conclude that in fact the strategy to lower the ancillary-wage costs by welfare state restructuring and flexibilization of the workforce has already undermined the social foundations of the German welfare state, multiplying the tensions between and within capital and labor organizations as well as Social Democrats and trade unions. Although the basic institutions of the social insurance system still exist formally, the situation of mass unemployment and low-wage labor under the condition of permanent austerity seem to transform the social insurance system into a more liberal welfare state regime. Under these circumstances, the social insurance system is insufficient to safeguard a standard of living in old age, to guarantee equal and universal access to health care services, and create new jobs through labor market and employment policies. Moreover, the rise in expenditures for the public social security system seems to have been halted for the time being by introducing more privatization measures for old-age provision and health care as well as promoting the duty to take care of one's self. This individualistic and privatization turn of German social policy might lead to a liberal transformation of the German welfare state, putting the commodification of labor, old age provision and health care on the agenda.

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NOTES

[1] Esping-Andersen's typology of the *Three Worlds of Welfare Capitalism* was criticized widely for its analytical flaws (e.g. Lessenich & Ostner, 1998; Schmidt, 1998a). Nevertheless, his seminal study and well-known typology are still used as an analytical framework for describing changes in welfare systems in industrialized countries (cf. Esping-Andersen, 1996; Schmid, 2002).

[2] This effect was exacerbated by the overall unification strategy. Despite criticism from experts, a broad coalition of Christian Democrats, Social Democrats and Liberals favored an instant monetary union and fast introduction of the West German Deutsche Mark (DM) into the East German economy with a 1 to 1 exchange rate (except savings). This led to a comprehensive breakdown in the competitiveness of East German companies. The subsequent mass unemployment intensified the financial burden on the social insurance system (cf. Czada, 1998).

[3] The net pension standard is a mathematical concept that describes the level of the old-age pension if one has worked 45 years as an employee, received exactly the average gross income each year, and made steady contributions to the statutory pension insurance during that time. Further, the resulting level is dependent on the annual indexation of old-age pension and reached 69.1% of the average net earned income in 2001.

[4] The calculation of individual old-age pensions is complex. Without going into detail, the amount of the individual pension is determined by (1) the period during which social contributions have been paid, (2) the income position during working life relative to the average wage income, and (3) the starting point of pension payments. These three aspects are contained in the pension formula (*Rentenformel*), which has been modified several times. Therefore, the pension is more or less equivalent to the paid social contributions during working life. Because of a ruling by the Federal Constitutional Court, the entitlements to pension derived from social contributions are equivalent to property.

[5] The calculation of future SPI contributory rates depends fundamentally on premises about future growth, future employment and future migration. Some studies conducted by the Commission for Demographic Change of the German *Bundestag* show very different projections of the level of the contributory rate for the public pension scheme in 2030, fluctuating between 23.3% and 27.9% (*Deutscher Bundestag*, 1998, p. 232).

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Chapter 8

KAI MOSEBACH

EROSION OF THE TAX BASIS

Fiscal Policy and International Tax Competition

1. INTRODUCTION

Market globalization and European integration are leading to increasing capital mobility. At the same time, internationally mobile companies are finding myriad opportunities to elude domestic taxation. The consequence is a loss of tax revenues for national governments generated by the corporate sector. Acknowledging this problem, the Red-Green administration introduced a major tax reform. This reform promised on the one hand to improve the international competitiveness of German firms and the attractiveness of Germany to foreign investors; on the other, together with a new economic and fiscal policy, it was to power an economic upswing in Germany.

This chapter will first address the issue of whether heightened international tax competition leads necessarily to an erosion of the financial base of modern government. While some tax experts argue that international tax competition would lead to the financial collapse of the (welfare) nation, the thesis offered here maintains that the effects of international tax competition are differentiated. Although global tax competition does not result in a complete abandonment of corporate and capital taxation, it is nonetheless a fact that internationally mobile companies can often elude taxation while domestic capital and immobile factors and goods bear a greater burden.

Under its first minister of finance, Keynesian-minded Oskar Lafontaine (Social Democratic Party [SPD]), the Red-Green administration aimed at bolstering the purchasing power of low-income and average-income groups at the expense of corporations and high-income groups, in addition to implementing an expansive fiscal policy. After Lafontaine's unexpected resignation, a more supply-side-oriented policy prevailed. The goals of this policy were to lessen the tax burdens on labor and capital in general and to enlarge the tax bases.

In the following, the structure of the national financial and tax system will be described as well as its significance for the German Model (*Modell Deutschland*).

S. Beck, F. Klobes, C. Scherrer (Eds.), Surviving Globalization?, 157—177.

Thereafter, the effects of international tax competition on national tax autonomy will be discussed. In addition, we will look at how Red-Green fiscal and tax policies have evolved since 1998, especially from the perspective of a strategic change in financial policy. Finally, we will assess the impact of the Red-Green financial and tax policies on the German Model.

2. FISCAL POLICY AND TAX SYSTEM IN GERMANY

The Federal Republic of Germany is a federal state whose responsibilities are distributed among the governments at federal, state (*Länder*) and municipal levels. Federal tasks cover primarily foreign relations, defense, social security, rail and postal services. The states are responsible for areas such as culture, public safety and justice. Nevertheless, many tasks are shared between the federal and the state government (Scharpf et al., 1976). These *Gemeinschaftsaufgaben* (joint tasks) include university construction, agricultural structure, educational planning and research financing, as well as the improvement of the regional economic structure (cf. Nowotny, 1999, p. 136). The strong role of the federal government in these areas is sanctioned by the constitutional obligation (art. 91 of the Basic Law) to work at a national level toward an "improvement of the living conditions in Germany". This is the reason why German federalism is also called "cooperative federalism". The federal, state and municipal authorities share revenues, enabling structurally weak and financially strapped states to ensure better living conditions through the delivery of services for general economic interest (*Daseinsvorsorge*). These services include the provision of roads, energy and water supply, as well as social services such as child care and health services. These responsibilities are met at the municipal level especially. The furtherance of approximately equal living conditions in Germany attests to the central importance of social consensus in the German Model (cf. Esser, 1998, p. 122).

In the wake of the European economic and monetary union, the conditions that have enabled this revenue sharing in Germany between the federal, state and municipal governments are changing as well (see Çağlar's chapter in this book). The federal financial ceiling has to comply with the provisions of the Stability and Growth Pact. This means that the various authorities have to coordinate financial policies among themselves in order to achieve a fair distribution of the burdens accompanying consolidation. In accordance with the Council Regulation (EC) No. 1466/97 on the strengthening of surveillance of budgetary positions and the surveillance and coordination of economic policies within the framework of the Stability and Growth Pact, the federal government submits annually a "Stability Program" to the Economic and Financial Affairs (ECOFIN) Council. This program shall provide information on the general government surplus/deficit ratio and measures being taken to comply with the provisions of the Stability and Growth Pact. In addition, the inclusion of §51a in the *Haushaltsgrundsätzegesetz* (*HGrG*, law on budgetary procedures) from 1 July 2002 has formalized a national "stability pact", which endeavors to coordinate the (medium-term) budgetary policy of the federal government and the states (communities) in line with European regulations.

This task has been assumed by the central federal coordination body, the Fiscal Planning Council (Schwarze & Snelting, 2002). The result is a multilevel financial policy-making system.

3. INTERNATIONAL TAX COMPETITION AND NATIONAL TAX AUTONOMY

Economists have varied opinions on international tax competition between countries. While some view international tax competition as a mechanism to oblige governments to use resources more effectively and efficiently (Blankart, 1996; Boss et al., 1999), others see unregulated international tax competition as a risk that could limit the government's ability to provide an efficient infrastructure and to fund social security systems (Sinn, 1997). Both discursive positions have the same theoretical premise: Namely, that the globalization of the economy and the opening of national economies make it impossible to tax mobile factors, that is especially capital taxation in the form of the corporate tax and the capital yields tax. The popular thesis of the erosion of the fiscal state through international tax competition holds that the economic integration of previously (relatively) closed national economies enables the predominately mobile production factor of capital to elude taxation. As a result of (desired) globalization processes, "in equilibrium the tax rate on capital [falls to] zero" (Frey, 1990, p. 89; quoted in Genschel, 2000, p. 67; translation: KM). However, this thesis lacks both empirical and theoretical grounds.

3.1. Conventional Wisdom and Empirical Evidence

The thesis of the eroding fiscal base of government needs to be examined in the light of the empirical evidence of national tax policy. An empirical study by the EU based on implicit tax rate indicators (Eurostat, 1997) shows that, until the mid-1990s, there was no evidence that taxation of capital was eroding.

The concept of implicit tax rates takes national tax revenues back to the macroeconomic tax base (capital, labor, consumption) from whence they came. Relating actual tax revenues to macroeconomic aggregates (components of the national income) delivers a so-called "implicit" tax rate. This approach is suitable for the international and intertemporal comparison of national tax revenues since it compares actual tax revenues, not just the different nominal or explicit tax rates. The empirical results show that, between 1970 and 1995, the EU-15 countries did not in general experience a dramatic decline in the rate of taxation. They also attest to the fact that tax on labor has risen, while the tax on consumption has experienced relatively constant growth over a long period of time (see Table 1.).

Table 1: Implicit Tax Rates in EC

	Other Factors			*Labor*			*Consumption*		
	1970 –75	1976 –85	1986 –95	1970 –75	1976 –85	1986 –95	1970 –75	1976 –85	1986 –95
Belgium	0.30	0.40	0.36	0.33	0.39	0.44	0.15	0.14	0.14
Denmark	0.23	0.31	0.39	0.38	0.39	0.45	0.19	0.19	0.20
Germany	0.44	0.51	0.41	0.32	0.37	0.41	0.14	0.13	0.13
Finland	–	0.14	0.21	–	0.40	0.48	–	0.18	0.19
France	0.28	0.45	0.45	0.31	0.37	0.43	0.17	0.15	0.15
United Kingdom	0.69	0.61	0.49	0.23	0.28	0.26	0.12	0.12	0.14
Ireland	0.28	0.25	0.22	0.18	0.25	0.31	0.18	0.19	0.19
Italy	0.19	0.23	0.32	0.23	0.32	0.41	0.12	0.11	0.13
Luxembourg	0.44	0.44	0.45	0.29	0.33	0.30	0.11	0.14	0.15
Netherlands	0.37	0.35	0.34	0.39	0.47	0.51	0.14	0.14	0.15
Austria	–	0.40	0.41	–	0.39	0.41	–	0.17	0.17
Sweden	–	0.32	0.42	–	0.53	0.55	–	0.15	0.17
EC-12 average	0.36	0.37	0.37	0.30	0.38	0.41	0.15	0.15	0.16
Source: Genschel, 2000, p. 273); 1.0 = 100%									

The average taxation for "other factors" (substituting for capital) rose slightly from 1970 – 1975 to 1986 – 1995 for all countries (from 0.36 to 0.37). A glance at the German trend however shows a slight decline in taxation from 0.44 (1970 – 1975) to 0.41 (1986 – 1995).

A subsequent study by the EU for the period 1995 – 2001 also failed to indicate an erosion in the rate of taxation (Eurostat, 2003).[1] Capital taxation has even risen since 1995. Only in 2001 did the tax burden on capital shrink in some countries, including Germany. Tax on labor and consumption remained for the most part constant: Over the period under observation, the tax on labor rose slightly while the tax on consumption eased a little (see Table 2.). These trends can be nothing more than an initial indicator of the tax burdens on corporations and private households and of the possible effects of international tax competition, because the aggregates contain very different components.[2]

Table 2: Implicit Tax Rates in EC (in %)

	Capital		*Labor*		*Consumption*	
	1995 – 2001		*1995 – 2001*		*1995 – 2001*	
	Average	Difference	Average	Difference	Average	Difference
Belgium	21.9	0.3	44.2	-0.3	26.4	4.9
Denmark	32.6	1.7	40.8	0.8	30.6	3.9
Germany	19.2	-0.5	39.5	0.4	24.0	1.4
Finland	28.5	0.4	44.7	-0.5	30.8	-0.5
France	23.0	-1.0	43.2	0.1	35.1	8.4
United Kingdom	21.5	-0.8	26.1	-0.3	31.4	7.6
Ireland*	26.0	1.3	29.7	-2.4	26.6	7.3
Italy	17.2	-0.5	37.8	3.8	27.9	2.0
Luxembourg	30.0	0.5	29.8	0.5	30.8	6.2
Netherlands	23.9	2.4	35.1	-3.3	29.0	7.0
Austria	21.8	1.1	39.0	1.2	25.8	7.0
Sweden**	28.1	-0.9	48.8	0.4	28.2	17.6
EC-15 average	23.2	0.6	36.9	0.4	27.5	5.9
Source: Eurostat, 2003; difference in percentage points; * = 1995 – 1999; ** = 1995 – 2000						

3.2. Different Taxation for Mobile and Immobile Capital

At first glance, the findings described above suggest that there are no observable negative effects of international tax competition on national tax autonomy. The aggregate data, however, hides differences between various capital forms. Transnational corporations can make use of many tax avoidance schemes that are not open to domestically operating companies. Thus, the “exit and voice” options are not available in equal measure (Wagschal, 2003; Jarass & Obermair, 2004).

The corporate tax system provides internationally acting groups and companies with a variety of instruments with which they can manipulate their tax on earnings. Among these is the *transfer price policy*, by which internationally operating corporations use internal transfer prices for internal services to transfer profits to the country where taxation of profits is lowest (Grözinger, 1999, pp. 250-258; *Sachverständigenrat* [SVR], 2003). Another strategy of these corporations and firms is to establish holding companies in tax oases and special taxation zones; the primary function of these holding companies is to finance the other parts of the corporation. The undercapitalization of these subsidiaries is compensated by loans to the financial holding. Because interest on borrowings is usually tax-deductible, the amount of profits tax can thereby be reduced or avoided (Genschel, 2000, pp. 278-279; Jarass & Obermair, 2004, pp. 97-104).

As regards personal income tax, international tax competition affects above all income from financial assets; that is, the taxation of interest and dividends. Moreover, the different types of income tax open the door to tax avoidance and illegal tax evasion. In Germany, the wage tax is withheld by the employer and paid over directly to the revenue office, while the remaining classes of income are reported to the revenue office in the income tax statement after the end of the tax period. The tax policies of many countries have nurtured this differential taxation of income by granting often hefty tax breaks for a large number of financial assets and by failing to provide adequate fiscal oversight in this area (Genschel, 2000, p. 281).

The federal government tries to compensate its lost tax autonomy with regard to internationally operating groups and corporations by raising taxes on immobile factors such as labor and on nationally based small and medium-sized companies (Trabold et al., 2001, p. 47). Thus an increase or stabilizing of implicit tax rates, that is real tax revenues, could be compatible with the thesis of fading national tax autonomy (cf. Genschel, 2000). The federal government's interest in itself (Claus Offe), its performance expectations on the one hand and the voice options of transnational capital on the other, give rise to a globalization dilemma: International tax competition increasingly deprives the federal government of financial resources for the fulfillment of its public duties. Two ideal types of strategy offer escape from this conundrum: The strategy of Neoliberalism and the strategy of international cooperation.

The strategy of *Neoliberalism* combines capital attraction initiatives with the policy of more consistent taxation of (immobile) production factors and goods. By extending special tax regimes and reducing nominal corporate and income tax rates, an attempt is made to compensate a nation's lost tax autonomy in the area of corporate taxation and capital income with a favorable position in international tax competition. In this manner, it is hoped that additional (investment) capital can be lured into the country. This carries the potential for a downward tax spiral, setting off the feared "race to the bottom" in tax policy (Tanzi & Bovenberg, 1990). Simultaneously, the federal government undertakes to tax immobile capital, labor and immobile goods more consistently and to close tax loopholes.

The strategy of *international cooperation*, on the contrary, works at the suprastate level in an effort to regain national tax autonomy with respect to mobile capital by concluding international agreements on corporate and interest taxation. The political approaches to match these strategies have yet to register success and do not go beyond voluntary codes of conduct (OECD) and often short-lived political initiatives at the EU level (Trabold et al., 2001, pp. 102-105; Mosebach, 2002, pp. 167-168). While value added tax rates have converged in the member states of the European Union, endeavors to achieve (minimum) harmonization of corporate and income taxation have stood still. This may be explained on the one hand by political deadlocks within the European multilevel system (no European financial and fiscal sovereignty; years-long compulsory agreement in the Council of Ministers).[3] On the other, the problems of European-wide tax harmonization have multiplied through the eastern expansion of the European Union. Many new member states of the EU have lower capital and corporate tax rates than, for example, Germany or France. They are resistant to European-wide harmonization of corporate income tax (Hoenig, 2004). Moreover, industry associations are often successful at portraying harmonization efforts as anticompetitive and know how to take advantage of the political deadlocks in the European multilevel system. Furthermore, a harmonization of capital taxation would give rise to considerable economic and political turmoil in the respective member states. An exodus of capital outside the EU economic zone is particularly feared. This accounts in part for the divergent interests in the EU Council of Ministers (Genschel, 2002, pp. 282-284).[4]

An analysis of the fiscal and tax policies of the Red-Green administration reveals that both strategies are being pursued. While the strategy of international cooperation prevailed under the administration's first minister of finance, Oskar Lafontaine, the Neoliberal strategy came increasingly to the fore after Lafontaine's resignation.

4. FISCAL POLICY AND TAXATION SINCE 1998

Upon winning the election on 26 September 1998, the new administration made up of the SPD and the Bündnis90/Die Grünen (The Greens) took office with the aim to once again conciliate the modernization of the economy with the goal of social justice and to break with the Neoliberalism introduced by its predecessors (SPD & Bündnis90/Die Grünen, 1998). The initial direction of financial and economic policies was referred to as the renaissance of Keynesianism in Germany (Schäfer, 1998). But with the loss of the state assembly elections in Hesse in March 1999, the Red-Green coalition lost its majority in the *Bundesrat* (upper house of parliament), creating a shift in the political power relations. Although the official rhetoric changed little after the resignation of finance minister and SPD chairman Oskar Lafontaine on 11 March 1999, the Red-Green financial strategy began to tilt more steeply to the supply side (Zolnhöfer, 2003a; see Beck and Scherrer's chapter in this book).

4.1. Challenging Globalization: Cooperative Keynesianism

After the Red-Green coalition assumed office, Oskar Lafontaine's economic policy followed a course similar to that taken by the French leftist government under Lionel Jospin (cf. Steinhilber, 2000). It targeted greater economic growth and a reduction of mass unemployment by means of raising mass purchasing power. In addition, Lafontaine tried to safeguard this strategy internationally by striving for a reorientation of the European Central Bank's monetary policy and through heightened taxation of transnational corporations and capital income. Both strategies failed in practice and were probably pivotal factors in Lafontaine's unexpected resignation as finance minister and SPD chairman on 11 March 1999.

4.1.1. Keynes at Home?

In Lafontaine's short term of office as minister of finance – a mere 136 days – a number of fiscal policy measures were initiated that indicated a turnaround in the economic and fiscal strategies of the Red-Green administration. First, demand-side-oriented experts were appointed to key positions in the finance ministry. The competence of the finance ministry was also enlarged to encompass European policy issues, which had hitherto been handled at the economics ministry. Second, both budgetary and tax policies were meant to mark a departure from the fiscal policies of the previous conservative-liberal administration.

The first budget, for which Lafontaine was still answerable, was expansive. In comparison with the previous year's budget, this one contained a growth in expenditure to the amount of 30 billion Deutsche Mark (DM) (or six percent over the previous year). Even if one accounts for the effects of the newly implemented "eco-tax", which should be co-financed by the Federal Subsidy for the Statutory Pension Fund (*Bundeszuschuss zur Gesetzlichen Rentenversicherung*), federal expenditure still increases by nearly two percent. It is impossible not to label the first Red-Green budget as "moderately expansive" (Zolnhöfer, 2003a, p. 67).

In his tax policy, Finance Minister Lafontaine formulated the necessity to close an "equity gap" caused by the tax policies of the previous conservative-liberal administration. As SPD chairman and premier of Saarland, Lafontaine played a pivotal role in the failure of the previous administration's tax reform in the upper house of parliament (*Bundesrat*) on 30 July 1997. At this time, the *Bundesrat* was dominated by state governments with Social Democratic (co-)leadership. Rather than bolster the supply side with tax cuts for large companies and higher income classes, Lafontaine pursued a policy of redistribution in order to lessen the burden on workers and families. Thus the 1999 income tax reform (*Steuerentlastungsgesetz 1999*) that came into force on 1 January 1999 lowered the initial rate of income tax and increased the basic tax-free allowance. The reduction of the top rate of income tax would first take effect by the year 2000 (*Steuerentlastungsgesetz 1999/2000/2002*). Furthermore, the reform axed significant tax privileges for corporations that had allowed them to reduce their real tax burden. Although the corporate income tax rate and the top rate of income tax for commercial income were slashed, the closing of tax loopholes effectively increased the tax burdens of many corporations (Zolnhöfer, 2003a, pp. 75-76).

4.1.2. International Cooperation Abroad?

Internationally, the new finance minister Lafontaine drew attention by publicly calling on the European Central Bank (ECB) to lower its base rate (Reiermann, 1998). Because the ECB had in early 1999 assumed responsibility for European-wide monetary policies, this demand violated a taboo: The ECB's political independence. This independence was secured through the toil of the conservative-liberal administration under Helmut Kohl, which went up against such critics as the leftist French government (cf. Gill, 2001). From Oskar Lafontaine's Keynesianist perspective, bringing European monetary policy in line with his expansive financial policy for Germany was the natural next step, because as it was, the ECB's monetary policy would have quickly counteracted such an expansive policy. Of course, Lafontaine failed in his efforts to influence the ECB, even though the ECB reduced its base rate some time after Lafontaine's resignation – as Lafontaine smugly noted (Lafontaine, 1999).

In the area of tax policy as well, the Red-Green administration strived initially for a more cooperative tax policy in Europe. Although no new initiatives in tax policy were started, Lafontaine – with Chancellor Schröder's approval – joined the French finance minister Dominique Straus-Kahn in trying to establish majority decisions in the EU Council of Ministers in matters of taxation. Together with the national tax policy, this might possibly have reduced tax competition and the tax avoidance possibilities of global corporations in particular. Additionally, the tax reform placed a heavier burden on these corporations, at least initially. The tax hikes were met by huge resistance from many major German corporations and were severely criticized by the German media, especially regarding the tax on energy consumption to promote ecological sustainability (the eco-tax) (Munsberg, 1999). In retaliation, Allianz Insurances and the energy suppliers RWE and Veba threatened in the media to transfer part of their business abroad if Lafontaine's tax proposals went through (Overbeek, 2000, p. 177).

4.2. Acknowledging Globalization: Fiscal Consolidation and Tax Reform

After Lafontaine's resignation, the rules of the European Growth and Stability Pact, which prescribed a restrictive budgetary and fiscal policy, as well as the conditions of international tax competition were accepted. While the budgetary policy was aligned with the guidelines of the Growth and Stability Pact, the supply-side tax policy aimed at overall tax cuts for corporations and private households amounting to 95 billion DM net (*Steuerreform 2000*). The tax relief for corporations should serve as an incentive to investments, make the companies more competitive and Germany more attractive to foreign investors. The income tax reform strived to increase the purchasing power of private households and, together with the anticipated investment boom powered by the corporate tax reform, revive the economy. However, accumulating tax revenue deficits and economic stagnation since 2001 led to rising public deficits, while the anticipated investment boom never materialized. The nation's financial crisis continued to worsen.

4.2.1. Fiscal Policy and European Integration: Confronting Stagnation?

The German economy is very sensitive to global economic trends owing to the German Model's unusually strong export orientation (see Beck's chapter in this book). Following the demise of the New Economy boom, the overall slump on the world stock exchanges and the economically contractive effects of 11 September 2001, the U.S. economy came to a standstill and the German economy followed suit. Despite numerous (usually quickly revised) optimistic growth forecasts, the German economy was unable to pull itself out of this cyclical dip (cf. *Deutsches Institut für Wirtschaftsforschung* [DIW] et al., 2002; 2003; 2004). While Neoliberal critics proposed radically cutting government spending and relieving citizens of dues and taxes (SVR, 2003), the Red-Green financial policy was based on a strategy of, as it were, "quadrature of the circle". On the one hand, to salvage its political credibility, the Red-Green administration wanted to satisfy the demands of the Growth and

Stability Pact; on the other, it could not afford to fully ignore the potentially contractive effects of the stability criteria during an economic slump (DIW, 2002).

The German government's financial planning for 2000 foresaw a balanced federal budget for 2006 (*Bundesministerium der Finanzen* [BMF], 2000), which would be achieved with a combination of measures. First, the federal budget would be relieved by 95 billion DM net by 2006; second, a tax reform would lessen the tax burden on corporations and citizens. The goal was to promote internationally competitive companies and an attractive location for foreign investment, as well as to raise the purchasing power of private households. Nevertheless, a stagnating global economy and a financial policy aimed at budget consolidation and tax relief combined to reverse the anticipated positive effects. Government expenditures rose primarily because of increased social spending. Public investment in the municipalities fell as a result of the budget consolidation, the shrinking economy and correspondingly lower tax revenues, and the high tax revenue deficits caused by the 2000 tax reform. Total net borrowing by the government increased (see Table 3.). In the updated federal budget plan from August 2003, the federal government acknowledged that it was no longer possible to keep its promise of a balanced federal budget by 2006 (BMF, 2003a).

Table 3: Governmental net financial investment, tax revenue and gross investments of regional authorities in Germany from 1991 to 2003 (in billion euros)

	1991	1994	1996	1998	1999	2000*	2001	2002	2003
Government revenue	663.1	808.3	859.2	898.9	935.1	955.3	942.5	949.5	n.a.
Government spending	707.4	850	921.9	941.6	964.5	981.6	1001.4	1023.9	n.a.
Overall public deficit	-44.3	-41.7	-62.7	-42.8	-29.4	-26.3	-58.9	-74.4	n.a.
In % of GDP	n.a.	n.a.	-3.4	-2.2	-1.5	-1.2	-2.8	-3.5	n.a.
Community tax**									
Wage tax	109.5	136.3	128.5	132.3	133.8	135.7	132.6	132.2	133.1
Assessed income tax	21.2	13.0	5.9	5.7	10.9	12.2	8.8	7.5	4.6
Corporate income tax	16.0	10.0	15.1	18.5	22.4	23.6	-0.4	2.9	8.3
Capital yields tax	5.8	16.1	13.0	17.7	17.4	20.9	29.9	22.5	16.6
Sales tax***	91.9	120.5	121.3	127.9	137.2	140.9	139	138.2	137
Federal taxes	47.3	53.9	70.5	66.7	72.2	75.5	79.3	83.5	86.6
State taxes	14.9	18.7	19.7	19.1	19.6	18.4	19.6	18.6	18.7
Municipal taxes****									
Local tax on trade and industry	21.1	22.5	23.5	25.8	27.1	27	24.5	23.4	n.a.
Property tax	5.1	6.5	7.5	8.3	8.6	8.8	9.1	9.3	n.a.
Gross investments	40.1	44.9	37.5	34.8	36.8	35.5	34.8	33.3	n.a.
Federal	6.5	6.4	5.8	5.6	7.6	6.2	6.5	6.5	n.a.

State	7.4	9.1	7.6	7.6	7.5	7.9	7.7	6.6	n.a.
Municipality	26.2	29.4	24.1	21.6	21.7	21.4	20.6	20.2	n.a.

Sources: SVR, 2003, Table 41/42; Deutsche Bundesbank, 2004, Table VIII.1–3)

*: Without once-only revenue from auctioning off UMTS licenses

**: Community taxes are apportioned among the three regional authorities differentially

***: Sales taxes are a) value-added tax and b) import sales tax

****: The community taxes include parafiscal revenues. The local tax on trade and industry and property tax make up the bulk of tax revenues.

4.2.2. Reforming Corporate Taxation

Private-sector companies (business partnerships or unincorporated companies and stock corporations) in Germany are subject to a complex, ever-changing taxation system. Accordingly, business partnerships are taxed under personal income tax, whereas stock corporations are subject to corporate income tax. Both partnerships and stock corporations must pay taxes on trade and industry, the bulk of which benefit the municipalities and essentially determine their public investment volume. To avoid double taxation on profits, companies can take advantage of the countless allowabilities among the various types of taxes (Homburg, 2000, pp. 313-327).

Revenues from the tax on trade and industry have declined markedly since 1999; corporate income tax revenues collapsed and were negative in 2001, that is tax refunds outnumbered revenues from this tax. Income tax including wage tax has also been retrograde since 2000 (see Table 3.). This strong reversal in corporate tax revenues is the result of two factors: Cyclical effects brought about partly by financial policy – witness the decline of the sales tax since 2000 – and tax policy.

Stock corporations and corporate income tax: The Red-Green coalition cut the tax burden on stock corporations considerably in a number of steps. Corporate income tax rates on distributed and undistributed profits were lowered from 45% and 40%, respectively, in 1998 to 25% for both in 2001. At the same time, several measures were introduced to extend the income threshold of the corporate income tax rate; in particular, depreciation allowances for companies were restricted (BMF, 2003b). But this in no way adequately offset the drastic tax rate cuts, because restricting depreciation allowances results in a greater tax load for companies only in the short term. In the subsequent period, the tax revenues generated from the corporate sector declined drastically. The corporate income tax revenues fell from 23.6 billion euros in 2000 to –0.4 billion euros in 2001 and rose only very modest to 8.3 billion euros in 2003 (see Table 3.). This free fall of corporate tax revenues can be blamed in part on a bundle of tax-cutting measures, as described below (cf. Jarass & Obermair, 2004, pp. 46-50; Schratzenstaller, 2002, pp. 60-61).

The reduction of the corporate income tax rates led to the situation where, for a transitional period of 15 years, companies are eligible for prorated tax refunds from the tax authorities if they intend to distribute earnings retained before 2001 after the adjusted corporate income tax rates. Tax refunds from earlier years effected an unforeseen decline in corporate income tax revenues, such that the tax authorities decided to apply a moratorium on corporate income tax refunds for "former capital entitled to imputation credit" until 2006 (Jarass & Obermair, 2004, pp. 49-50; Schratzenstaller, 2002, pp. 58-60).

A further reason for the enormous deficits from the corporate income tax lies in the tax exemptions on capital gains by stock corporations. The ones who benefit most from this are consolidated companies.

> "The Deutsche Bank accounted for capital gains of 2.3 billion € in their balance sheet for the first half of 2002; Allianz had capital gains of 2.3 billion € for Mannesmann/Vodafone and MünchnerRück alone." (Jarass & Obermair, 2004, p. 49; translation: KM)

While this may have fueled the restructuring of the *Deutschland AG* (see Kellermann's chapter in this book), considerable tax revenues were lost.

An important role in the decline of the corporate income tax was played by the revised rules for forming a corporate entity from 1 January 2001. In a taxable entity, which can be made up of several independent companies, current and earlier profits and losses can be offset among the participating companies. The revised rules have markedly lowered the threshold for forming a corporate entity.

> "Since 2001 the only condition for a taxable entity aside from the conclusion of a profit and loss transfer agreement has been a majority stake in a company. Companies that are interlinked solely because of majority holdings but are otherwise independent have additional possibilities now of reducing their corporate income tax obligation." (Schratzenstaller, 2002, p. 59; translation: KM)

Besides these domestic tax shelters for stock corporations, there are the aforementioned possibilities of relocating the tax base of stock corporations to foreign countries via transfer prices and financial holdings (see above).

Business partnerships and income tax: Partnerships in Germany fall under the personal income tax law because the taxes on their profits are paid by the shareholders. The majority of small and medium-sized enterprises in Germany have the legal form of business partnerships. Contrary to internationally operating groups and corporations, small and medium-sized enterprises (SMEs) solely oriented to the domestic market can make little use of the manifold international opportunities to avoid taxes on corporate profits. In its 2000 tax reform, the Red-Green administration cut income tax rates across the board in order to provide tax relief to business partnerships as well. Nevertheless, partnerships bear a greater tax burden than do stock corporations (Schratzenstaller, 2002, p. 62).

The downside of international tax competition becomes apparent here: The tax burden on small and medium-sized enterprises rises relatively to that of internationally operating stock corporations, which can enjoy the benefits of the tax arbitrage. But what the small and medium-sized enterprises still have is the "great domestic tax shelter": Illegal employment (Trabold et al., 2001, p. 101). For the fiscal authorities, however, illegal employment means that considerable tax revenues and social insurance contributions are lost. As a result, efforts are underway to prosecute illegal workers more rigorously (Bonstein & Dettmer, 2004).

Tax on trade and industry and the crisis of the municipal finances: In comparison with the federal government and the states, the municipalities finance only about a third of their responsibilities out of their own tax resources (2001: 33%). The heart of communal taxes is the local tax on trade and industry, whose assessment basis, the business income, has been standardized nationally. The municipalities are nevertheless free to define the applicable tax rate themselves by means of a multiplier, the so-called *Hebesatz*. An allowance applied to partnerships and sole proprietors is meant to lower their taxes on trade and industry in relation to those paid by stock corporations. Besides the tax on trade and industry, the municipalities finance their services through charges and fees, but predominately through a complex fiscal equalization scheme with the respective state government. Municipalities thus depend heavily on the fiscal and tax policy of higher authorities, especially with respect to community taxes (income tax and sales tax) as well as block grants and specific grants for investment projects (Bach & Vesper, 2002).

The lowering of the income tax rates, as well as the change to their assessment bases, has a direct impact on the revenues of the municipalities: Certain tax agreements with the federal and state authorities (*Verbundsteuer*) oblige municipalities to bear their share of any cuts. Moreover, the states have frequently passed consolidation costs on to the municipalities by cutting the grants available to municipalities. Furthermore, the federal government and the states repeatedly devolved tasks upon the municipalities without providing the resources to fulfill them (ibid.). The municipalities consequently had to adhere to strict spending limits throughout the 1990s (Arbeitsgruppe Alternative Wirtschaftspolitik [AAW], 2003, p. 140).

Annual municipal investments dropped sharply from 33.1 billion DM (1992) to 24.2 billion DM (2001). This led to the closure of public institutions (swimming halls, libraries, social services) and staff cuts. "The municipalities are – on average – chronically underfunded" (Bach & Vesper, 2002, "*Entwicklungstendenzen*", para. 8; translation: KM).

The Red-Green administration has aggravated the poor economic climate with its pro-cyclical fiscal and tax policies. But cyclical effects are not the only reason for the decline in tax revenues for municipalities. Revenues from taxes on trade and industry have shrunk on account of partially tax-exempt dividend payouts among stock corporations. Moreover, a business tax entity was created that, similarly to the corporate entity, allows independent companies connected via majority holdings to offset their profits and losses in a manner that reduces taxes on trade and industry. Ultimately, the municipalities were affected most severely by the revenue shortfalls resulting from the income tax reform (cf. AAW, 2003, pp. 140-152).

4.2.3. Promoting International Tax Competition?

According to the German Council of Economic Experts (*Sachverständigenrat*, SVR), the tax burden on German companies, notwithstanding the diverse tax-cutting measures introduced by the Red-Green administration, is still too high in international comparison. Both the *effective marginal* tax rate and the *effective average* tax rate of stock corporations for 2001/2002 were higher in Germany than in Sweden, Italy and Ireland. The *Sachverständigenrat* believes that these differences account for the decline in gross capital investment from 436.1 billion euros (2000) to 378.8 billion euros (2002) (SVR, 2003, p. 552, p. 309; SVR, 2001, pp. 296-316).

Aside from the fact that the demand side is completely neglected, the Council's argumentation is based on dubious theoretical and empirical concepts of tax burden calculation in international comparison. On the one hand, their method of calculation is premised on a *notional* tax load of companies that plan future investment. They explicitly do not consider real, retrospective tax burdens of companies and stock corporations. In their opinion, this retrospective view is irrelevant for future investments (SVR, 2003). This argument would be tenable only if investors suffered from general amnesia or, alternatively, had access to detailed information on future market developments. The retrospective experience of real, low tax burdens for companies will in any case influence investment decisions. The calculation method for the notional tax load is highly susceptible to varying rules for determining assessment bases, pre-tax returns, capital market rates, future inflation rates, and so forth. The various models for computing the hypothetical tax load of companies differ significantly from one another, such that they have only limited forecasting value (cf. AAW, 2003, pp. 167-171). Moreover, tax avoidance strategies can translate into a major deviation between real and notional tax payments.

Furthermore, results of a comparative study by the European statistics office (Eurostat) on capital taxation in Europe show that, in 2001, Germany had the second lowest (behind Greece) real tax burden on the macroeconomic factor of capital (property tax, wealth tax and capital yields tax). The total tax burden on capital was 24% in 2001 (Eurostat, 2003, p. 93; see Figure 1.). A similar situation existed in the 1990s for German corporate taxation in international tax competition, as confirmed by an OECD study on corporate income tax and wealth tax as well as by an EU study on corporate subsidization. These studies attest to the fact that the Red-Green corporate tax reform is based on false premises. Therefore, even before the tax reforms went into effect, the thesis of Germany as a high-tax country with respect to corporate taxation, particularly the taxation of stock corporations, was not tenable (Grözinger, 1999). Hence, one can argue justifiably that the lessening of the tax burden for German companies through the 2000 tax reform could have jump-started (ruinous) international tax competition (Heise et al. 2000; Grözinger, 2000; see also Tables 1. and 2. above).

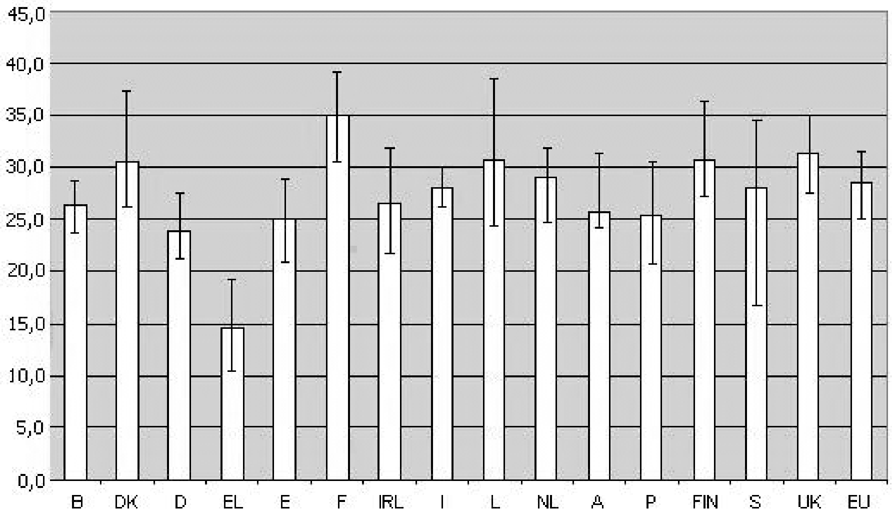

Figure 1: Implicit tax rates on capital in EC Average 1995 – 2001 in % and minimum and maximum level over that period (Source: Eurostat, 2003, p. 93)

4.2.4. Lowering Income Taxes: Stability or Crisis Promotion?

Income tax reform was part of the Red-Green political agenda from the very beginning. The initial rate and top rate of income tax were lowered and the basic tax-free allowance, below which income is tax-exempt, was increased (see Table 5.).

Table 4: Development of income tax scale benchmarks, 1998 – 2005

	Basic tax-free allowance in €	*Initial tax rate in %*	*Top rate in %*	*Limit of progression in €*
1998	6,322	25.9	53	61,377
1999	6,681	23.9	53	61,377
2000	6,902	22.9	51	58,643
2001	7,206	19.9	48.5	54,999
2004	7,664	16	46	52,152
2005	7,664	15	42	52,152
Source: Schratzenstaller, 2002; BMF, 2003b				

Despite adverse economic trends, income tax rates were lowered further in 2004. While the initial tax rate fell to 16%, the maximum tax rate sank to 45%. The tax reform is to be concluded in 2005 with the envisaged lowering of the top rate to 42%

and the initial rate to 15% (BMF, 2003b). Because most of the concomitant losses of tax revenues cannot be funded by net borrowing, the deficits have to be compensated by cuts in government expenditure, especially in social spending and transfers. Whether these measures will spur growth is uncertain (DIW, 2004).

Through the income tax reforms of the Red-Green administration, all income classes bear a lesser tax burden. Yet relative relief differs between income classes: Top earners enjoy greater relief thanks to the marked lowering of the top rate of income tax and the limit of progression. Whether the tax relief of low- and middle-income groups will enhance the purchasing power of private households in these income segments – which the federal government is banking on – remains unknown for the reasons detailed below.

First, numerous tax breaks for lower and middle income classes have been slashed, while legal tax avoidance loopholes for companies and property holders were left unclosed thanks to pressure from corporate associations and other lobby groups. Second, the planned reintroduction of the wealth tax for the benefit of an interest income tax of 25% was shelved. Speculative profits from private sales of assets were separated from income tax and are now only subject to a settlement tax of 15%. Similarly to dividend payments, they are also only taxed up to 50% (so-called "half-income system"), which translates into an effective tax rate of 7.5% (*Steuervergünstigungsabbaugesetz* 2003). At any rate, this rules out equal tax treatment for all income types (AAW, 2003, pp. 117-119). Third, the consolidation efforts on the part of the government and the sluggish economy in Germany increase social insurance spending. The anticipated effect of the tax cuts on demand could fail to materialize if increases in social security contributions and/or increases in fees due to privatizations were to reduce the consumption ratio of the lower and middle income classes.

5. CONCLUSION: RED-GREEN FISCAL POLICY AND TAXATION

The Red-Green fiscal and tax policy had set itself the goals of enhancing the international competitiveness of German firms, spurring economic growth, and conciliating the goal of social justice with the modernization of the economy. The reform of corporate and income taxes has resulted in a sustained decline in capital taxation. Germany has the second lowest (behind Greece) implicit tax rates for capital among the group of 15 "old" member states of the European Union. The taxation of income has also been nominally reduced. Contrary to expectations, however, this tax policy has not yet led to sustained economic growth. Moreover, in the course of the global economic slowdown at the beginning of the new millennium, German financial policy – particularly after the early resignation of Oskar Lafontaine as finance minister – has had pro-cyclical effects owing to efforts to meet the criteria of the European Growth and Stability Pact. Particularly the public investments of municipalities, after having declined dramatically in the 1990s, have fallen again sharply since 2000. In consequence, the provision of public services for general economic interest and for maintaining the social consensus in the German Model has been called into question. The current sluggish economy puts the goal of more social justice nearly out of reach because, in the Social Democratic view, the means for redistribution have to be gained through high economic growth.

Germany is not the only country to repeatedly fail to meet the criteria of the European Growth and Stability Pact. What is needed is a discussion about how to deal more realistically with the sometimes high-handed criteria of the pact, so that monetary and financial policies coordinated at the European level have no pro-cyclical effects. In an enlarged European Union, it remains to be seen whether this reorientation can be realized, along with the urgent need to contain harmful tax competition. It is nevertheless likely that the carousel of international tax competition will continue to turn. This may result in an increasing shortage of funds to achieve the political objective of harmonizing living conditions in all regions of Germany. In any case, it would be folly to rely solely on the instruments of authoritarian Neoliberalism. The European level is of central importance for enabling growth-oriented monetary and financial policies, the containment of international tax competition, and the protection of public services (AAW, 2004, pp. 213-245; Fritz, 2004, pp. 30-35; Genschel, 2002). A renationalization of policies in Europe cannot solve the dilemma of economic globalization. Whether the proverbial social consensus of the German Model can be kept afloat in the 21st century against this background depends on the degree to which international, that is primarily European, cooperation gains the upper hand in matters of financial and tax policy.

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NOTES

[1] Because of different statistical systems used, the figures from the 2003 Eurostat study cannot be directly compared with the findings of the precursor study from 1997.

[2] Taxes on consumption consist of different subtypes: VAT-type taxes, taxes and duties on imports, taxes on products and productions, poll taxes, and payments by households for licenses. Taxes on labor encompass taxes, payroll taxes and social contributions for employed as well as non-employed persons. Finally, taxes on capital are defined both by capital and business income taxes as well as taxes on stocks (wealth) (Eurostat, 2003, pp. 49-55).

[3] Since the Treaty of Nice amending the Treaty on European Union, majority decisions have broken down to the extent that individual countries have been able to agree on tax harmonization within the framework of “enhanced cooperation” without being blocked.

[4] The strict banking confidentiality in Switzerland is seen as the main reason why no agreement has been reached at the European level concerning EU interest income tax. The recent agreement between the EU and Switzerland, which provides that Swiss authorities collect taxes on interest income from third countries whose citizens seek to evade taxes through the flight of capital to Switzerland, does not prevent tax evasion (Neitzel, 2004). In addition, its enactment in Switzerland will very likely be tied to a referendum, so that the provision will not enter into force on 1 January 2005 as planned.

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Chapter 9

GÜLAY ÇAĞLAR

EUROPEAN INTEGRATION

Consequences for the German Model

1. INTRODUCTION

The project of establishing a Common Market in Europe is continuously challenging the political and institutional settings for policy-making at national level (Börzel, 1999; Ladrech, 1994). This is particularly true for some of the institutional features of *Modell Deutschland*. In this chapter, I will elaborate on how European regulations affect institutional arrangements in Germany. In this context, I will predominantly focus on the following features of the German Model: First, the specific role of state authorities in actively promoting industrial growth, the development of network industries (i.e. transport, telecommunications, and energy), and securing equal living conditions throughout Germany. Second, the institutional settings for interest mediation between capital and labor, such as the collective wage bargaining system and codetermination at board level.

Since the mid-1980s, European integration has primarily been furthered by the aim of creating a Single European Market in order to strengthen Europe's competitiveness in the global economy (Bieling & Steinhilber, 2000). The Single Market Program (1985) introduced a new rationale for policy-making at European level: Competition.[1] Ever since, intra-European competition has been regarded as a driving force for realizing the common market. Accordingly, European regulations are geared toward abolishing all barriers to the free flow of goods, services, people, and capital within the European Union (EU). National political and institutional peculiarities are considered impediments to the establishment of a common market. For this reason, European competition and liberalization policies are of utmost importance to roll back national regulatory regimes and thus to foster intra-European competition. Moreover, the establishment of the European Monetary Union in 1999 and the European Company Statute in 2001 were further major steps toward the completion of the Single European Market: The introduction of the Euro and of a common corporate law conduced to the removal of legal and economic barriers to cross-border activities within Europe.

S. Beck, F. Klobes, C. Scherrer (Eds.), Surviving Globalization?, 179—200.

These European dynamics trigger pressure toward a reconfiguration of the political and institutional settings of the German Model. The question is *how* institutional changes in the context of Europeanization occur. Institutional adaptation to the common market requirements at the national level does not only come about through EU laws, Commission directives, and European Court rulings. Knill and Lehmkuhl (1999) identified two more mechanisms of change: One mechanism relates to EU rules that affect institutional arrangements at national level by "altering domestic opportunity structures, and hence the distribution of power and resources between domestic actors." (Knill & Lehmkuhl, 1999, p.1) Consequently, the direction of change is not foreseeable as it depends vastly on internal struggles. The other mechanism refers to European activities that are changing the beliefs and expectations of domestic actors. As will be shown in this chapter, these mechanisms are not mutually exclusive and may work simultaneously.

This chapter is primarily focused on the aforesaid regulations at European level and their implications for the German Model. First I will outline the European competition provisions applying to companies and particularly to state aid and scrutinize how these rules affect efforts by state authorities to provide for industrial development and equal living conditions throughout the national territory. In Part 2, I will introduce the European Company Statute and its accompanying directive on employee involvement at board level and discuss whether the German Model of codetermination at board level is jeopardized in the case of the formation of a European Company. Finally, I will elaborate on the implications of the European Monetary Union on the collective bargaining system in Germany. These examples will show that pressure on the German Model does not just arise from the imposition of European regulations that directly aim at institutional adaptation. In fact, different mechanisms of change are in effect eroding the institutional arrangements of *Modell Deutschland.*

2. RESTRUCTURING THE EUROPEAN MARKET: COMPETITION POLICY

European competition policy is regarded as one of the major tools for realizing the target of the common market. The aim is to counteract transactions by private firms or policy measures by Member States that impair competition in the European Union (Ehlermann, 1995). Accordingly, European competition policy focuses on four main areas of action:

(1) Elimination of concerted strategies between competitors (cartels) and of abuses of the dominant position on the market;

(2) merger control;

(3) liberalization of monopolistic sectors (e.g. telecommunications and energy sectors);

(4) state aid control.

European rules applying to state involvement in the national economy are set up in Articles 86 and 87. Article 86 subjugates public and private undertakings "entrusted with the operation of services of general interest" (European Community [EC], 1999, pp. 148-149) by state authorities to the existing competition rules. Therefore, European competition law serves as a legal framework for deregulation policies of the European Commission. Article 87 refers to the issue of state aid, stipulating that

> "[…] any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, insofar as it affects trade between Member States, be incompatible with the common market." (EC, 1999, p. 149)

State aid is prohibited within the European Union, barring some exceptions that permit state aid under certain circumstances. All these provisions affect policies oriented toward national developmentalism, which is one of the basic elements of the "German Model". Particularly the European provisions on monopolistic sectors and state aid influence the direction of industrial and regional policies (Kantzenbach, 1996; Tetsch, 1999), thereby narrowing the scope for action to promote industrial development, sociospatial cohesion, and economic growth in the German economy (see Section 2.3. of this chapter).

European competition regulations not only limit the scope of Germany's industrial and regional policies but also determine the implementation of German competition law. While both laws preside in parallel, EU legislation takes precedence over national legislation in the event of European competition being impaired by private undertakings. In other words, German legislation takes priority in cases where regulations and objectives of European competition law are not infringed (Schmidt & Schmidt, 1997, p. 10).

2.1. Two Objectives: Competition and Competitiveness

While the regulatory framework on competition gradually pushes back industrial and regional policies at national level, legal regulations relating to industrial policy at European level are set up in the Treaty of Maastricht (Kantzenbach, 1996, p. 53). The incorporation of title XVI "Industry" and the corresponding industrial-political regulations in Article 157 firmly establish the goal of promoting Europe's industrial competitiveness and, consequently, extending the competency of the European Commission to include the area of industrial policy. Article 157(1) stipulates the following:

> "The Community and the Member States shall ensure that the conditions necessary for the competitiveness of the Community's industry exist. For that purpose, in accordance with a system of open and competitive markets, their action shall be aimed at:
>
> - Speeding up the adjustment of industry to structural changes;
> - encouraging an environment favourable to initiative and to the development of undertakings throughout the Community, particularly small and medium-sized undertakings;

- encouraging an environment favourable to cooperation between undertakings;
- fostering better exploitation of the industrial potential of policies of innovation, research and technological development." (EC, 1999, p. 235)

This means that both goals – the protection of competition and the strengthening of industrial competitiveness – are put on a par with each other. Evidently, while pushing back national policy measures regarding industrial development, the European regulations aim at strengthening industrial policy at European level. Liberal scholars criticize that the European regulatory framework on competition is misused for industrial-political goals. Moreover, they emphasize that industrial policy at European level, particularly the goal of "encouraging an environment favourable to cooperation between undertakings" (ibid.) in Article 157, will promote a trend toward economic concentration in Europe (Weiss, 1998, p. 101; Immega, 1993, p. 157).

The developments within Europe do indeed point to rising economic concentration within Europe. Obviously, there is a bias toward industrial goals in the context of European merger control. As mentioned earlier, mergers that lead to market domination and thus to competition restraints are not compatible with the goals of a common market and are therefore prohibited. However, the definition of the spatial market demarcation (*räumliche Marktabgrenzung*) plays a major role when it comes to prohibiting a merger. The European Commission defines markets rather broadly in referring to the global market instead of the European market (Kantzenbach & Kinne, 1997, p. 79). This increases the probability of corporate mergers on a European scale.

The developments in the European regulatory framework on competition point clearly to a shift toward a competition policy that is determined by the objective to promote Europe's industrial competitiveness. Consequently, corporate concentration in Europe will be furthered. This assessment is definitely reinforced by the current decision regarding the European Company Statute (see Section 3. of this chapter).

2.2. Liberalization: The Introduction of Competition in Monopolistic Sectors

According to an important exemption in German competition law, German authorities concede monopoly rights to undertakings to provide services of general economic interest, such as telecommunications, transport, and energy. However, under European competition law (Article 86, par. 2), this is not permitted. In this respect, German competition law conflicts with Community law. Article 86(3) endows the European Commission with the competency to ensure the application of Article 86(2) that subjugates undertakings in question to the rules on competition (EC, 1999, p. 149). The European Commission is indebted to the objective of fostering intra-European competition by removing national regulatory regimes that impede the creation of a single market in which services of general economic interest can be easily supplied across national borders. Accordingly, in the 1990s, the European Commission has increasingly made use of its right to address directives to the Member States relating to the liberalization of monopolistic sectors, such as telecommunications, postal services, transport, and energy (Kantzenbach, 1996, p. 49; Vollmer, 1997, p. 294). In this manner, the Commission has contributed to the implementation of the Single Market Program (1985).

Community liberalization directives have accelerated the deregulation and liberalization processes within the Member States. The Commission differentiates infrastructure from commercial activities. Liberalization policies primarily relate to commercial activities, while infrastructure remains unaffected (European Commission, 2000, p. 26). This means that the exclusive ownership of infrastructure (e.g. a telephone network) continues to be tolerated.

In Germany, the telecommunications and the energy sectors were already opened up to intra-European competition in 1998 (Hellermann, 2000; Reichard, 2000). Other services of general economic interest are also subject to liberalization efforts. As municipalities are responsible for the provision of some services of general economic interest (i.e. public transport, water, and energy), liberalization policies affect their scope of action to decide on the provision and quality of services at local level (Hellermann, 2000, p. 2). In fact, the rapid liberalization efforts in Germany have triggered public apprehension relating to the questions of sufficient provision and the quality of such services. These concerns were picked up by a number of EU Member States and led to the insertion of Article 16 into the Treaty of Amsterdam. Article 16 exempts to a certain degree public services from European deregulation policies:

> "Without prejudice to Articles 73, 86 and 87, and given the place occupied by services of general economic interest in the shared values of the Union as well as their role in promoting social and territorial cohesion, the Community and the Member States, each within their respective powers and within the scope of application of this Treaty, shall take care that such services operate on the basis of principles and conditions which enable them to fulfil their missions." (EC, 1999, p. 89)

Accordingly, public authorities are required to ensure that these services fulfill their mission of serving the public adequately. For this purpose, public authorities may grant special rights and financial support to suppliers of such services (Fritz & Scherrer, 2002, p. 14). Moreover, in a *Communication* on "Services of general interest in Europe", the European Commission stipulates that action has to be taken at the "appropriate level, Community, national regional, or local level […] to establish criteria for services of general interest." (2001, p. 6) This actually corresponds with the principle of subsidiarity applied in German federalism.

To what degree Article 16 actually exempts public services from liberalization is a matter of controversy. Bernhard Nagel (2000, p. 759) emphasizes that the Commission is turning away from its deregulation policy in opening up possibilities for re-regulation at national level. In contrast, Thomas Fritz (2004, p. 6) points out that there is no indication of the abandonment of deregulation policies. Article 16 does not leverage competition rules. The objective to promote intra-European competition takes precedence over safeguarding the provision of services by national suppliers (European Centre of Enterprises with Public Participation and of Enterprises of General Economic Interest [CEEP], 2003, p. 8).

However, Article 16 leaves room for interpretations concerning the question whether the European Commission attempts to set up standards for the provision of services. On a legal basis, European authorities are not yet authorized to directly regulate the service sector (Vollmer, 1997, p. 199). Nevertheless, the Commission tends to set standards for the provision and quality of services, as it did in July 2000, in suggesting a decree on transport services (Gewerkschaft Öffentliche Dienste, Transport und Verkehr [ÖTV], 2000; Bundesrat, 2000).

2.3. State Aid Control: The End of German Regional and Structural Policy?

As already mentioned, European state aid control is an important tool of the European Commission for ensuring that intracommunity competition is not distorted by the individual aid schemes of Member States. The Commission predominantly takes action against systematic aid (European Commission, 2000, p. 30). Particularly since the end of the 1980s, the Commission has been carrying out its activities relating to state aid more rigorously (Wishlade et al., 2003, p. 11). This has an effect on German spatial planning policies and particularly on aid schemes for companies in deprived areas. Regional and structural policies are quite important in Germany, as the objective of improving the living standards throughout the national territory is set up in the German Constitution. National developmentalism, the role of the central state, and the institutional arrangement of "cooperative federalism"[2] in the area of regional and structural policy are specific to the German Model (Brenner, 2000), which, in this respect, is jeopardized by European competition provisions.

The so-called "joint-task for the improvement of regional economic structures"[3] (*Gemeinschaftsaufgabe zur Verbesserung der regionalen Wirtschaftsstruktur*), which was set up in the German Constitution in 1969, determines regional and structural policies in Germany. The instruments for promoting investments in less developed regions and thus industrial growth throughout the national territory are mainly investment subsidies for companies and infrastructure investments (Brenner, 2000, p. 323). Policy-making in the context of the joint task is basically characterized by so-called "interlocking politics" (*Politikverflechtung*) between the central and the federal state level (*Länder*) (Scharpf et al., 1976). This means that authorities at central and federal state level are both politically and financially[4] responsible for regional and structural policy in Germany (Rosenfeld, 1999). Policy-making in the joint task is based on consensus, which means that representatives from the central and the federal governments cooperatively decide on criteria for regional aid schemes, such as funding levels, area designation, and regional policy objectives (Thielemann, 1998, p. 20). These decisions are annually put down in a framework plan, which has to be approved by the European Commission according to Article 88 (EC, 1999, pp. 150-151.).

European competition law concedes exceptions to the general ban of state aid in Article 87(3)(a) and (c): Certain forms of aid that contribute to development in lagging areas are accepted (EC, 1999, p. 150). Of special interest for Germany is particularly Article 87(2)(c), which permits state aid exclusively to those regions affected by the division of Germany.

Although these regulations leave Germany (and of course other Member States) some room for maneuver to support lagging regions, the European Commission interferes in the decisions on area designation and funding levels. The approval of national and regional aid schemes depends on “the percentage of the population covered by designated aid areas.” (Wishlade et al., 2003, p. 15) For instance, in 1999, German aid areas covered 40.7% of the population. This differs significantly from the guideline ceiling of 34.9% set by the Commission (ibid., p. 33). Consequently, the European Commission rejected Germany’s regional aid map and required Germany to give up 5.8% of its population quota (Bachtler et al., 2003, p. 37; Yuill & Wishlade, 2003, p. 4). This shows that European criteria determine area designation and, consequently, the scope for regional policies at national level.

Moreover, European state aid control also refers to the level of subsidies granted to firms. A prominent case of state aid control is for instance the Volkswagen dispute. In 1995, the Saxon authorities, referring to Article 87(2)(a), intended to subsidize Volkswagen investments in Mosel and Chemnitz with an aid package of EUR 398 million. The European Commission, however, approved just EUR 275 million (European Commission, 2000, p. 33). The Commission argued that these subsidies were additional to other aid that was already approved by the Commission (ibid.). A decision of the Commission on state aid is actually legally binding. Under pressure from VW, the State of Saxony ignored the Commission’s decision and went on paying the full amount of subsidies to Volkswagen (Thielemann, 1998, p. 11). Consequently, the Commission initiated legal proceedings against the Federal Republic of Germany. Without going into the legal details, this case shows how the Commission intervenes in aid policy schemes if they are considered to be an impediment to intracommunity competition.

However, European aid directives are criticized as they restrict national structural policy measures and thus hamper regional development (Tetsch, 1999; Lammers, 1999). Tetsch gives an example, referring to the European Commission’s resolution on “Multisectoral framework of regional aid for large-scale investment projects”[5] in 1998. This aid provision restricts state aid for large-scale investment projects by stipulating that the European Commission determines the level of subsidies on the basis of its own criteria in the case of investment projects exceeding a predetermined threshold value (Tetsch, 1999, p. 374). Tetsch emphasizes that the Commission goes so far as to allocate greater subsidies to investment projects that appear to be forward-looking:

> “The Commission may lower already approved aid schemes by about 85 percent maximum if investments are considered by the Commission to be too capital intensive (less labor intensive), leading to a dominant position in the market or to overcapacities and promising no positive effect on regional development. […] Hence no effective regional advancement can be pursued.” (ibid.; translation: GC)

However, the European Commission is limiting Germany’s regional and structural policies not just by using the instrument of state aid control but also by extending its own competencies in the area of regional policy (Tetsch, 1999, p. 373). The goal is to reduce economic disparities and thus to promote economic and social cohesion within Europe. The European Structural Funds are the central tool for European structural and regional policies.[6] Structural subsidies are granted on the basis of specific criteria that are set up in the “Agenda 2000”, which is a resolution on European structural and regional policies for the years 2000–2006 (Wulf-

Mathies, 1999). Regions eligible for European grants are determined according to the following criteria: Firstly, regions that have a gross domestic product per capita of less than 75% of the EU average are classified as "regions lagging behind development" and thus come under Objective 1 of the European Structural Funds. Secondly, regions in structural crisis are eligible for funding under Objective 2. Finally, all regions that need support to combat unemployment get funding for education, training, and active labor market policies (Objective 3) (European Commission, 1999, pp. 10-11). All regions are comprised under Objective 3 apart from Objective 1 regions. Besides the structural funds, there is a cohesion fund specifically for countries whose gross domestic product per capita totals less than 90% of the EU average. The purpose of this fund is to support countries preparing for membership in the European Economic and Monetary Union. The distribution of monies in the cohesion fund is calculated according to the convergence phase a country has attained (Wulf-Mathies, 1999, p. 367). In sum, the level of funds available in the context of European regional policy in the period from 2000 to 2006 amounts to EUR 213 billion (Gabrisch & Ragnitz, 2001, p. 144).

European structural subsidies are of specific importance for eastern Germany. Currently, the eastern *Länder* are classified as Objective-1-regions. In the course of European enlargement, however, the EU average GDP will decrease and the eastern *Länder* will lose their status as Objective-1-regions (Ragnitz, 2002, p. 46). Because of limited funds under Objectives 2 and 3 (10% and 11% of the total amount), some scholars expect that subsidies for industrial growth in eastern Germany will be significantly reduced (Gabrisch & Ragnitz, 2001, p. 144). However, provisional arrangements for eastern Germany are due to negotiations with the European Commission.

Evidently, European competition and regional policies are restricting Germany's scope for action to promote industrial development in deprived regions and thus the equalization of living conditions throughout the national territory. The European Commission affects the German system of cooperative federalism by strengthening its own competencies in the area of regional policy: It determines national policy objectives by setting the criteria for aid eligibility of regions, area designation, and the level of state subsidies.

3. EUROPEAN COMPANY: IS EMPLOYEE INVOLVEMENT IN JEOPARDY?

The European Company Statute[7] is a further step toward a single market in Europe. The incentive for creating a corporate law in Europe was to reduce the obstacles for companies contemplating to merge across national borders. Until recently, cross-border mergers were unfeasible due to differing national corporate laws within Europe (Theisen & Wenz, 2002, p. 26). The European Company Statute provides a single set of rules for companies operating in different member states and therefore facilitates cross-border mergers and joint ventures within Europe.

A decision on the Statute for a European Company (hereinafter referred to as SE)[8] was pending for close to thirty years because member countries had never come to a joint agreement on a regulation regarding employee participation at board level. Ultimately, in December 2000 the European Council achieved a political consensus on a directive concerning the involvement of employees in the SE.[9] The statute was finally passed in the European Parliament in September 2001 and adopted by the European Union in October 2001. The provisions enter into force in October 2004 provided that the directive on employee involvement in the SE has been transferred to national legislation by each member state (ibid., p. 35).

The issue of employee involvement is at the heart of forming an SE, due to differing national provisions and practices. Questions arise in the context of different standards of employee involvement in the member states: Are higher standards in some countries an impediment to forming an SE with companies from these countries? Or, is the SE a way for these companies to evade national rules of employee involvement?

Before elaborating on these questions, however, it is important to clarify, what is meant by "involvement of employees": In Article 2(h) of the directive, "involvement" is defined as "any mechanism, including information, consultation and participation, through which employees' representatives may exercise an influence on decisions to be taken within the company." (EC, 2001a, p. 24) Information and consultation procedures allow employees' representatives to analyze questions concerning the SE and to express an opinion that can be taken into account in the decision-making process within the SE (ibid.). Participation means the right to elect or to influence the selection of the members of the company's board (ibid.). The issue at stake is particularly employee participation at board level, since informing and consulting employees through representatives of the employees is anyway mandatory in all SEs (EC, 2001a, p. 22).

During the process of formation of an SE, it is compulsory to address the issue of employee participation: The SE regulation provides that an SE may not be registered unless an arrangement for employee participation has been achieved (EC, 2001b, p. 6). If the negotiating parties (management and employee representatives) fail to agree upon principles for participation, standard rules, set up in the annex to the directive, come into application (EC, 2001a, p. 27). The purpose of those requirements is to prevent the SE from becoming a way of evading national rules regarding employee participation at board level (Davies, 2003, p. 84). Therefore, it is not predetermined that employee participation will be abolished in the course of cross-border mergers or joint ventures within Europe. It rather depends on the circumstances in which an SE is created.

3.1. The "Before and After" Principle for Realizing Employee Participation

An important feature of an SE is the transnational dimension of its formation procedure (Buchheim, 2001). An SE may be formed by a number of companies "provided that at least two of them are governed by the law of different Member States." (EC, 2001b, p. 4) There are four ways of establishing an SE: By means of a merger, by forming a joint holding SE or joint subsidiary SE, and finally by transforming a single company into an SE, provided that for at least two years this company has operated a subsidiary company subject to the law of another member state (ibid.). These different formation procedures are critical for arranging participation rules within an SE.

As mentioned before, the directive does not set up a uniform European model of employee participation. It merely stipulates a procedure for negotiating arrangements for the participation of employees within an SE: Corporate management and administrative organs of companies contemplating to form an SE are required to take up negotiations with employees' representatives immediately. Employees' representatives of the participating companies are required to create a special negotiating body (EC, 2001a, p. 24). Member states may provide that trade unions may also partake as members in this special negotiating body. Negotiations must be finalized within six months; however, the parties involved may consent to extend the period of negotiation up to one year (ibid., p. 27). If the negotiating parties do not reach an agreement during this period, standard rules on employee participation would apply. At this juncture, the existing national provisions on employee participation at board level are of utmost importance: Participation at board level is not compulsory if none of the founding companies was subject to national laws that provided participation rights for employees (EC, 2001a, p. 32). As already mentioned, the directive just stipulates that the management body of an SE keeps employee representatives informed and consults with them on a regular basis. Whether participation rights are granted depends very much on the legal rules on board-level participation that existed in the home countries of the founding companies prior to the formation of an SE. In other words, the standard rules call for employee participation if at least one of the companies involved in forming an SE was subject to such legal rules in its home country. This is referred to as the "before and after" principle (Köstler, 2002; Davies, 2003).

However, the standard rules do not automatically apply. Whether the standard rules become effective depends on the proportion of the workforce covered by mandatory participation before the creation of an SE (EC, 2001a, p. 27):

(1) In the case of an SE formed by a merger, the standard rules apply only if, prior to the registration of the SE, employee participation existed in one or more of the involved companies covering at least 25% of the total number of employees.

(2) In the case of an SE formed by setting up a holding or subsidiary, the threshold of the total number of employees is 50%.

(3) In the case of an SE established by transformation, the standard rules apply if legal rules of member states regarding employee participation applied to a company transformed to an SE.

This clause illustrates that legal rules regarding board-level participation cannot be circumvented easily. In fact, the "highest level" requirement, set up in the directive, facilitates the “export” of the most advanced participation systems (Davies, 2003, p. 87).

The European Company Statute and the rules in the directive have set off a controversial debate in Germany on the status quo of national law concerning codetermination at board level.

3.2. German Companies: Unattractive Partners for an SE?

A significant feature of the German corporate governance system is the separation between the management board and the supervisory board. The supervisory board, composed of shareholder and employee representatives, is an important body, as it appoints the members of the management board and controls its performance. The management board is required to inform the supervisory board on important questions regularly and to make available reports on the financial status of the company. The supervisory board scrutinizes the decisions made at management level. Moreover, certain transactions of the management board are subject to the approval of the supervisory board. Consequently, codetermination on the supervisory board is pivotal for employee representatives to participate in corporate decision-making and thus to exert influence on corporate strategies. The right of codetermination in Germany is far reaching as it goes beyond the mere right of information access and hearing attendance.

Codetermination is laid down in the Coal, Iron and Steel Industry Codetermination Act of 1951, the Industrial Constitution Act of 1952 and the Codetermination Act of 1976. The composition of shareholder and employee representatives on the supervisory board varies according to the size of the companies: The Codetermination Act of 1951 prescribes full-parity participation in companies with more than 1,000 employees in the mining and steel industries. In other industries, the proportion of employee representatives on the board varies from one-third in companies with more than 500 employees (Industrial Constitution Act of 1952) to quasi-parity in companies with more than 2,000 employees (Codetermination Act of 1976). Quasi-parity relates to the situation of stalemate in a vote, in which the chairperson of the supervisory board, who is a shareholder representative, has a casting vote (Müller-Jentsch, 1986.).

The parity and quasi-parity formula respectively triggered controversial altercations between employers and trade unions in the beginning. When the Codetermination Act was passed in 1976, employer associations immediately instituted legal proceedings against the Codetermination Act, albeit without success (Wood, 1997, p. 3). Ever since, codetermination at board level is a significant feature of industrial relations in Germany. In comparison to other member states, Germany grants far-reaching codetermination rights. This actually has been continuously subject to contention as employer associations stress that the parity formula impedes decisions in the interest of a company and thus reduces its flexibility, efficiency and competitiveness (Schulten et al., 1998). Currently, opposition against the existing codetermination model particularly increases in the context of the European Company Statute and its accompanying directive.

Representatives from German business criticize that the standard rules provide that "the most far-reaching codetermination model applies for companies involved in the founding of a European Company." (Bundesverband der Deutschen Industrie [BDI], 2001, p. 2) They fear that this might "render German companies unattractive partners for the formation of an SE, at least where the other founding company or companies come from other systems which do not require board-level participation." (Davies, 2003, p. 76) Consequently, they call for restrictions in employee participation at board level in order to promote the attractiveness of German companies for cross-border mergers and joint ventures within Europe (Rogowski, 2003, p. 9).

The directive on employee involvement at board level revitalized severe criticism about the far-reaching codetermination rights in Germany. Consequently, the German Model of codetermination is threatened rather more by forces within Germany and less by the legal regulations on the European Company per se. Scholars stress that the relatively high level of employee participation in Germany will *formally* remain unaffected by the provisions (Buchheim, 2001, pp. 163-164). However, it is not yet definite whether the German codetermination model will apply to companies involved in creating an SE. The maintenance of employee participation prevalent in German companies will ultimately depend on the negotiations between employee representatives and the management of the companies forming an SE (Streeck, 1998, p. 236). At this point, solidarity of employees and trade unions of the companies involved will be of utmost importance to preserve employees' rights to equally participate at board level (Davies, 2003).

4. EUROPEAN MONETARY UNION: GERMAN CORPORATISM UNDER PRESSURE?

One of the most challenging issues in the course of European integration is obviously the introduction of a single common currency in Europe. In connection with the launching of the Euro in January 1999, the scope of national economic policy coordination has diminished: The exchange rates among the participant countries are irreversibly fixed and the responsibility for monetary policy has shifted from the domestic level to the European level. Nowadays, the European Central Bank (ECB) determines monetary policy within Europe. Moreover, the convergence criteria, set up in the Maastricht Treaty, restrict national fiscal policies in defining a threshold for acceptable budget deficits. The aim is to promote budget discipline within the member states in order to enhance stability and growth. Accordingly, budgetary discipline is defined as a budget deficit of less than three percent of the gross domestic product (GDP) and a debt ratio not exceeding 60% of the GDP (Steuer, 1998; Müller, 1998).[10] These fiscal criteria narrow the member states' scope for action in the event of external economic shocks.

Simultaneously, the European Monetary Union (EMU) also affects industrial relations within member states. While monetary policy becomes European, labor policies remain at the national level (Boyer, 2000, p. 42). This raises questions about how the scope for action of wage-bargaining institutions, and therefore their wage-setting behavior, is changing. How does the EMU affect corporatist arrangements in Germany? These questions are controversially debated in Germany. Yet before investigating the implications of the EMU, it is important to briefly introduce the main features of Germany's collective bargaining system.

4.1. Collective Bargaining in Germany

Collective bargaining in Germany primarily takes place in industries or sectors at the regional level.[11] A significant feature of the industry-wide collective bargaining system in Germany is the principle of collective bargaining autonomy (*Tarifautonomie*) that is set up in the German constitution. Trade unions and employer associations have the right to negotiate collective bargaining agreements autonomously without any interference on the part of the state. This means that the negotiating parties are responsible for determining basic employment conditions such as working times, wages and supplementary benefits in a sector or industry. All members of the signatories are bound to the collectively agreed standards until the expiration of the agreement. In fact, employers bound to the sectoral framework agreement (*Flächentarifvertrag*) are required to apply the agreement just to trade union members working in their company. However, employers usually extend the agreement also to those employees who are not members of the trade union, even though they are not legally forced to do so. Employers are principally interested in avoiding friction within the company due to differential treatment (Ulman & Gerlach, 2003).

Moreover, by means of the so-called "universal binding force" (*Allgemeinverbindlichkeitserklärung*), the applicability of an agreement can also be extended to employers and employees who are not affiliated with the contracting parties. At the request of one of the negotiating parties, the Federal Minister for Labor can declare an agreement as generally binding for the whole sector in the region. In that case, all companies in the region are obliged to grant every employee the collectively agreed standards. However, there are two preconditions for the applicability of the universal binding force. Firstly, at least 50% of all employees within the sector and region have to be employed in companies that are bound by the collective agreement in question. Secondly, the universal binding force must serve the public interest, that is prevention of wage dumping and competition at the expense of employees within a sector. The legal procedure for the universal binding force is of particular importance for employees working in very small businesses that are not members of any employer associations (Zagelmeyer, 1997; Behrens, 2002).

The specific characteristics of the German bargaining system have strengthened labor *vis-à-vis* capital. Cooperative arrangements have prevented serious industrial conflicts. However, since unemployment is continuously increasing and economic conditions are changing, the main features of the German bargaining system are being seriously questioned and trade unions are becoming politically weakened.

4.2. Wage-Setting Behavior of Trade Unions

Discussions about changes in corporatist arrangements predominantly draw on the work of Calmfors and Driffill (1988). The (neo-classical) Calmfors-Driffill model explains the relationship between national bargaining systems and unemployment in modeling how the degree of centralization of collective bargaining affects real wages. In the model, wage-bargaining systems in different countries range from decentralized systems at company level to centralized systems at the national level. The central argument is that both highly decentralized and highly centralized decision-making in the wage-setting process brings about wage restraint and therefore reduces the level of unemployment. In contrast to this, systems in between (industry-level bargaining) lead to significantly higher wages and consequently to higher unemployment (Calmfors & Driffill, 1988). This argument is referred to as the "hump-shape hypothesis" (Franz, 1997). However, scholars strongly question the theoretical explanations of the Calmfors-Driffill model (cf. Soskice, 1990; Traxler & Kittel, 2000; Traxler, 2002a).

Calmfors and Driffill assume that trade unions are in a monopolistic position to determine nominal wages, whereas the employers decide on the level of employment. Trade unions are primarily concerned about the level of real wages on the one hand and about the level of employment of its members on the other hand. Accordingly, the wage-setting behavior is shaped by these considerations. The behavior in a decentralized bargaining system is explained as follows: It is assumed that an increase in nominal wages at company level leads to a reduction in employment, as higher nominal wages push up the product prices and consequently reduce product demand. In this situation, moderate wage-setting behavior is expected: Trade unions raise nominal wages merely to the extent that they do not affect the level of employment negatively. Therefore, the wage-setting behavior at company level tends to be competition oriented (Schweickert, 1996, p. 192).

In the case of a centralized bargaining system, other factors are decisive for the behavior of trade unions: It is assumed that one monopolistic trade union determines the nominal wage for all workers in the national economy. Changes in nominal wages have an effect on the national price level. Thus, an increase in nominal wages leads automatically to higher inflation, which triggers countermeasures by the national central bank in order to curb inflation. The impact of a tightened monetary policy by the central bank is a reduction in employment. In this situation, none of the trade union's goals can be realized: Neither a rise in real wages can be achieved nor can the level of employment be held constant. It is assumed that trade unions anticipate the central bank's response to changes in the price level. Accordingly, as trade unions are aware of the economic significance of their wage-setting behavior at the national level, they choose to perform moderately (Rürup, 1997, p. 42). Wage-setting behavior at the national level is employment oriented and thus responsive to monetary policy (Schweickert, 1996, p. 192).

Wage-setting behavior in intermediate bargaining systems is assumed to be significantly less moderate since "intermediate bargaining can work as a cartel, enabling the bargaining parties to externalize the costs of a pay hike to other groups by jointly raising the output price." (Traxler, 2002a, p. 15) Thus, the difference between the extreme degrees of centralization and the intermediate bargaining system is that in the former system trade unions internalize wage externalities.

Since collective bargaining in Germany takes place in industries at the regional level, Calmfors and Driffill categorize the degree of centralization as intermediate. However, Soskice (1990) argues that Calmfors and Driffill undertake a wrong classification. Instead, he puts emphasis on the level of coordination, which is not necessarily identical to the formal level of collective bargaining. Although industries or sectors at the regional level are formally the main sites of collective action, coordination at the national level exists informally. In Germany, wage settlements in the multi-industrial metalworking sector frequently influence wage-setting processes in other industries. This is due to the size and the bargaining power of the metal workers' trade union IG Metall (Ulman & Gerlach, 2003, p. 3). Coordination takes place through "pattern bargaining" led by IG Metall (Sisson & Margison, 2000, p. 15): A pilot agreement in one of the regions (usually Baden-Württemberg) determines other collective bargaining agreements within the industry on the one hand and across industries on the other hand (Martin, 1998; Soskice, 1990). Consequently, employment relations are highly standardized in Germany. Owing to the informal coordination of collective bargaining, the degree of centralization in Germany can be classified as relatively high (Horn et al., 1999, p. 35).

IG Metall is primarily concerned about the level of employment within the export-oriented metal sector, which includes the automotive, engineering and steel industries. Accordingly, in previous bargaining rounds (particularly in the 1980s), the wage-setting behavior of IG Metall was moderate (productivity oriented) since the union was aware of the signaling character of the key wage settlements for the entire economy. The union consistently internalized the conservative monetary policy of the central bank (Bundesbank), in order to avert anti-inflationary policies and an exchange rate appreciation that would have jeopardized the international competitiveness of the metal sector (Soskice, 1990, p. 45).

However, the emergence of the EMU has changed the scope for action of the bargaining parties. The question that is mainly debated among scholars is whether the central characteristics of the German collective bargaining system, such as *Tarifautonomie* and *Flächentarifvertrag*, will finally be given up in order to be competitive in the single common market. Of course, this question is not new, as it has been discussed since the beginning of the 1990s. The emergence of the EMU has furthered certain institutional changes that will be illustrated in the following section.

4.3. EMU: Implications for Collective Bargaining in Germany

The establishment of the EMU entails the extension of the entire economic and currency area. Accordingly, the economic performance of member states is no longer limited to the national economic area. In fact, the share of German products in total demand within the European Union is minor in comparison to the share of products in total demand in Germany. Consequently, wage settlements in Germany hardly influence the price level within the EMU area. The German Committee of

Experts on Economic Development[12] points out that an inflation rate of five percent in Germany (assuming that the rate of inflation in other member states remains constant) causes an increase of just 1.73% in the European price level (Sachverständigenrat [SVR], 1998, p. 177). Therefore, within the EMU area the German collective bargaining system can be classified as intermediate. German trade unions are no longer confronted with the austere monetary policy of the Bundesbank at the national level. At the European level, the ECB is primarily concerned about economic developments within the entire European economic area. This lowers the incentive for trade unions to consider macroeconomic developments. In line with the "hump-shape hypothesis", one could argue that the wage-setting behavior of German trade unions will be less moderate in the EMU area (Schweickert, 1996).

At the same time, however, competition within Europe is being reinforced: In the EMU, production costs and product prices are easily comparable. Since competitiveness can no longer be achieved through a devaluation of national currencies, nominal wages remain (besides elevated productivity and state subsidies) as the only instrument to reduce export prices in order to regain competitiveness (Fröhlich et al., 1997, p. 9).[13] In this context, German trade unions' scope for action has been limited tremendously, as they are forced to be more competition oriented (Traxler, 2002b, p. 282). In the course of intensified competition in Europe, trade unions have to take into account wage-setting strategies of their counterpart unions.

The new macroeconomic conditions in Europe have strengthened those forces in Germany that call for wage settlements even below productivity growth and for more flexibility in the labor market. This provokes controversial debates on the direction of institutional changes in German corporatism. Obviously, the pressure toward outright decentralization is continuously growing: Particularly employer associations press for a highly decentralized bargaining system, calling for the abolishment of sectoral framework agreements, as they perceive these agreements as too rigid and thus as major restrictions for companies to adjust to changing economic circumstances (Bispinck, 2003, p. 396). Members of the Liberal and the Christian Democratic parties politically support this position. They all put emphasis on the need for total autonomy of companies in determining wages and working conditions in order to be cost competitive (ibid.). The backing of the employers associations' position by liberal and conservative politicians is actually not surprising. More astonishing though is that even the Social Democratic chancellor, Gerhard Schröder, bluntly demands more possibilities for regulations at company level.[14] In supporting the discourse on flexibility, the Social Democratic government politically dissociates itself from trade unions and consequently erodes the unions' bargaining power.

In contrast, trade unions insist on the importance of sectoral framework agreements that secure minimum standards and equal working conditions for employees. They criticize the polemic discussions on the rigidity of sectoral framework agreements and argue that built-in "opening clauses" (*Öffnungsklausel*) offer an opportunity for companies under certain economic circumstances to diverge from collectively agreed standards. In fact, since the beginning of the 1990s, trade unions and employer associations have increasingly agreed upon such opening clauses on wages and working conditions in sectoral framework agreements (Schulten, 1997). As a result, German corporatism is already subject to decentralization, albeit in a coordinated manner (Traxler, 2002b, p. 284). Trade unions fear that uncoordinated decentralization can trigger downward competition within the member states (Dullien & Horn, 1999, p. 62). In order to prevent wage-dumping strategies and a "beggar-my-neighbor" mentality, European trade unions recently started various initiatives to coordinate collective bargaining at the European level (Traxler, 2002b, p. 282), such as the European Industry Federations or the non-sector-specific European Trade Union Confederation (Mermet & Hoffmann, 2001). Another initiative is the so-called "Doorn group", which was established in 1998 by different trade unions from Germany, Belgium, Luxembourg, and the Netherlands. The trade unions concerned agree upon bargaining guidelines, which are set up in a joint declaration. According to the Doorn coordination formula, wage settlements have to correspond to the total sum of inflation and productivity growth (Schulten, 2000). All these supranational initiatives provide platforms for information and coordination at the European level. However, there is no indication that this will lead to the Europeanization of collective bargaining in the near future (Schulten & Bispinck, 2001, p. 11).

5. CONCLUSION: SURVIVING EUROPEANIZATION?

The purpose of this chapter has been to show how European regulations, aiming at the realization of the common market, affect the German Model. Evidently, the European regulatory procedures all put pressure on the political and institutional arrangements of the German Model. However, this pressure toward institutional adaptation and Europeanization is exerted via different mechanisms.

The European regulatory framework on competition is directing Germany (and of course other Member States) to scale down state aid schemes relating to the promotion of investments in deprived regions. This limits state authorities' scope for action to fulfill their constitutionally enshrined task of ensuring equal living conditions and social cohesion in Germany. The European Commission is shaping national policy-making through directives and its competency to prohibit certain national policies that do not comply with European rules.

Concerning the European Company Statute and the directive on employee involvement at board level, the EU's influence works through different mechanisms: The directive actually intends to prevent that the European Company becomes a way of evading national systems of employee participation at board level. In fact, the "highest level" requirement allows for the adaptation of the most advanced participation systems. Consequently, the institutional orientation of the directive itself is principally in accordance with the German Model of codetermination at board level. However, the European Company Statue and the provisions on employee participation have revitalized debates and thus have triggered significant pressure on codetermination rights in Germany. In this context, the European economic dynamics of accelerated competition and the increased tendency toward market concentration play a crucial role, as they have an influence on the domestic opportunity structures and the power relations between employee and employer representatives. Employer associations have gained "discursive" power by relating to these dynamics and evoking the worst-case scenario of German companies as unattractive partners for establishing an SE and thus losing economic power. The prospect of dismissals is inherent to this argumentation.

The mechanism for change in the context of the European Monetary Union is actually akin to the European Company Statute. The EMU has changed the macroeconomic conditions for collective wage bargaining, putting trade unions increasingly under stress of competition within the entire European economy. These new macroeconomic conditions have strengthened those forces in Germany that call for more flexibility in the labor market and even demand the abolishment of sectoral framework agreements. Currently, the trend toward decentralization of wage bargaining is evident.

As the last two cases show, European political and economic dynamics improves the strategic position of those actors that try to get rid of the political and institutional arrangements of the German Model. This shift is putting trade unions and employee representatives increasingly under pressure to develop new strategies in order to regain bargaining power. New political arrangements and practices have to be developed at a supranational level, building on solidarity among trade unions and employees throughout Europe.

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NOTES

1 The goal of creating a Single European Market was particularly pushed forward by the export-oriented capital fraction that was organized in the so-called "European Roundtable of Industrialists". Bastiaan van Apeldoorn (2000) shows that the policy agenda of the Single Market Program was significantly shaped by these transnational capitalists.

2 Since reunification and in the context of accelerating globalization, however, cooperative federalism in Germany has been politically contested. For further details on this issue, see Neil Brenner (2000).

3 Gesetz über die Gemeinschaftsaufgabe "Verbesserung der regionalen Wirtschaftsstruktur" (GRW) vom 06.10.1969, BGBl. I. There are two other joint tasks besides the one governing regional policy: Joint task for university construction and joint task for the improvement of agricultural structures and coastal protection (Thielemann, 1998, p. 19).

4 Both the central and the federal government have to provide financial resources for an aid scheme. The resources of the central government are earmarked and have to be financially supplemented by the federal government (*Mischfinanzierung*) (Rosenfeld, 1999, pp. 3-4).

5 Multisectoral Framework of Regional Aid for Large scale Investment. Official Journal of the European Communities, 98/C 107/05 (European Commission, 1998).

6 There are four European funds: European Regional Development Fund (ERDF), European Social Funds (ESF), Guidance Section of European Guidance and Guarantee Fund (EGSS) and Financial Instrument for Fisheries (FIFG) (European Commission, 1999, p. 9).

7 Council Regulation (EC) No. 2157/2001 of 8 October 2001, OJ L 294/1 (EC, 2001b).

8 SE is the abbreviation of Societas Europaea, which is the Latin translation for European Company.

9 Council Directive 2001/86/EC of 8 October 2001 supplementing the statute for a European Company with regard to the involvement of employees, OJ L 294/22 (EC, 2001a).

[10] However, the Stability and Growth Pact concedes some exceptions to these budgetary rules: The deficit may exceed three percent of the GDP temporarily if a member state faces serious economic recession, which is defined as a decline in GDP of more than two percent.
[11] As there are sixteen regions in Germany (*Länder*), each industry or sector negotiates sixteen collective agreements.
[12] Sachverständigenrat zur Begutachtung der wirtschaftlichen Entwicklung.
[13] This is conceptualized in the theory of optimal currency areas (Mundel, 1961). For further theoretical investigations, see Heise (2002), Mermet & Hoffmann (2001).
[14] Talk, 14 March 2003.

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Chapter 10

STEFAN BECK, CHRISTOPH SCHERRER

EXPLAINING THE DYNAMICS OF RED-GREEN ECONOMIC REFORMS

1. INTRODUCTION

Contrary to popular headlines of *Reformstau* (reform deadlock) in Germany, substantial economic reforms have taken place in the past few years. Changes in specific policy areas have been well documented in the preceding chapters. Here we want to take a look at the political dynamics behind the reforms. We will start with a short summary of how the red-green economic reform agenda has evolved since the coalition of the Social Democratic Party (SPD) and the Green Party (Bündnis90/Die Grünen) was voted into office in September 1998. We will then theorize about the factors that might account for the observed reform dynamics.

We have identified three phases of the red-green reform agenda. The phases have been named after their leading policy entrepreneurs:

(1) "Lafontaine-Trittin phase" (9/1998 – 3/1999), which saw the implementation of long-held red-green policy ideas that strengthened core features of *Modell Deutschland* (German Model).

(2) "Eichel-Riester phase" (4/1999 – 2/2002), which led to a cautious reversal of the previous policy stance, substantial tax relief for corporate Germany, and a break with the principle of "parity" contributions to pension funds.

(3) "Hartz-Clement phase" (3/2002 – 3/2004), during which the "Agenda 2010" of massive cuts in the welfare system was developed and imposed.

In view of his party's massive loss in popularity, dwindling membership base, prospective defeats in state elections, and a revolt among union leaders, Chancellor

S. Beck, F. Klobes, C. Scherrer (Eds.), Surviving Globalization?, 201—223.

Gerhard Schröder stepped down from the leadership of the Social Democratic Party in March 2004, which may have marked the beginning of a new phase. The leader of the Social Democratic faction in parliament, Franz Müntefering, has succeeded him. Müntefering is considered to be closer to traditional social democratic values. Thus, we may be on the verge of a "Müntefering phase", which may ultimately drop some of the more radical proposals of the Agenda 2010. Our focus, however, will remain on the first three phases.

The shifts from one phase to another raise a number of questions. What needs to be explained first is why the shifts have had a weakening effect on the institutional features of *Modell Deutschland*. Second, it remains a mystery why, in the second, Eichel-Riester phase, despite the abandonment of the original agenda that favored the core constituency of the coalition government, some programs favored by this core constituency were nevertheless enacted. Third, the adoption of the unpopular Agenda 2010 remains puzzling, especially from hindsight.

For an answer to these questions, neither models in line with the assumption that voters determine government actions (the Downs' tradition) nor models working with the assumption that parties maximize the preferences of their members seem to hold (Aldrich, 1995; Roemer, 2001). These models would predict policies much more in line with voters' or party members' preferences. We will therefore turn to theories of hegemony, which we believe help explain the broader context in which the events have unfolded. Within this context, we will assume that actors behave rationally.

Our main hypothesis is that when the left is on the defensive because of a lack of mobilization capabilities and absence of an intellectually attractive agenda, a left-of-center coalition government will feel under pressure to veer to the middle.

2. THE FIRST STEPS OF RED-GREEN: THE LAFONTAINE-TRITTIN PHASE

The red-green coalition came to power in September 1998 after 16 years of a conservative-liberal government under Chancellor Helmut Kohl. Its election appeal beyond the powerful slogan of change after the long Kohl era rested on a mélange of three vague modernization promises. The then Social Democratic candidate for chancellorship, Gerhard Schröder, seemed to stand for a pro-business job creation and modernization strategy, which would later become known as the "Third Way", mapped out in the Blair-Schröder paper (Schröder & Blair, 1999). Oskar Lafontaine, the Social Democratic Party leader, stood for egalitarian growth strategies, and the Greens were identified with the project of ecological and societal modernization. Together, these promises of both economic competitiveness and ecological and social sustainability remained as obscure as the slogan of Chancellor Schröder: "Wir werden nicht alles anders, aber vieles besser machen" ("We will not change everything but will improve many things"). The new government promised to lower unemployment, but the way to achieve this goal was not spelled out clearly. By heralding "a wise combination of demand-side and supply-side economic policies", the coalition agreement left enough room for broad interpretation (Kreutz, 2002; Eicker-Wolf, 2002).

To the surprise of many, Chancellor Schröder managed to persuade his perennial competitor, Oskar Lafontaine, to become his finance minister. By joining the cabinet, Lafontaine gave up his independence as a party leader and subordinated himself to the policy-making powers of the chancellor. Apparently, he received no guidance and felt free to set out on his own. He took on board two known Keynesian economists, Heiner Flassbeck and Claus Noé, as his permanent secretaries and plotted a Neo-Keynesian course: Fiscal stimulation, increase of mass consumption through lower tax rates for low-income households, targeted exchange rates, international coordination of tax policies, stronger financial oversight, and the coaxing of the European Central Bank to lower interest rates (see Mosebach's chapter on tax policies in this book).

Jürgen Trittin of the much smaller Green Party (in the 1998 federal elections, The Greens obtained 6.7% and the Social Democrats 40.9% of the electoral vote) stood for an ecological reform of the German economy, the opting out of nuclear energy, a reform of asylum rights, and the introduction of dual citizenship. These two left-leaning ministers were not alone in their attempt to reverse years of Christian Democratic policies; their cabinet colleagues also rescinded measures of the previous government:

(1) The reduction of sick payment and construction workers' "bad weather compensation";

(2) the lowering of protection against dismissals and the offsetting of severance pay against unemployment benefits;

(3) cuts in the health care system (e.g. dentures, hospital and drug costs);

(4) gradual reduction of pensions from 70% to 64% of the last wage received as well as cuts in pensions for invalids.

In 1998, the new government picked up on a suggestion by Klaus Zwickel, the then leader of the metal workers' union IG Metall, and established the so-called "Alliance for Jobs" (*Bündnis für Arbeit, Ausbildung und Wettbewerbsfähigkeit*). While the conservative-liberal government often acted in a confrontational manner toward the trade unions, the red-green coalition had the support of the trade unions at the beginning (cf. Eironline, 1998) and tried to present their "modernization program" as a nonpartisan challenge embracing all societal forces (Kreutz, 2002). However, the employers, confirmed in their aversion to Lafontaine and the first decisions of the red-green administration, had more than enough reasons not to cooperate, at least until this "specter" had disappeared. Moreover, apart from being called a "decision-taker", the Alliance was charged with having conflicting intentions: While the government wanted, and the employers demanded, to talk about wage policies, unions made it clear that they would not tolerate this encroachment on voluntary bargaining (*Tarifautonomie*). Furthermore, macroeconomic policies, in particular monetary and fiscal policies (a coordinated wage policy would make sense only in this context), were not part of the agenda. Lafontaine had promoted such macroeconomic coordination of EU employment policy within the "Cologne process" (one of the three "pillars" of the European Employment Pact introduced at the Cologne summit in June 1999 during the German presidency of the EU Council of Ministers). After his resignation, however, the red-green coalition no longer pursued this approach (Heise, 2002a). In the long run, apart from comparatively unproblematic issues such as training and education, the results of the *Bündnis für Arbeit* talks have been modest. Indeed, the Alliance for Jobs was little more than a discursive framework for the promotion of the new Social Democratic "supply-side corporatism" (*Angebotskorporatismus*); nevertheless, it "helped" to motivate the (long ago disciplined) unions to pursue a modest, employment-securing wage policy (Niechoj, 2002; Heise, 2002b).

In addition, a crash program ("JUMP") targeting the reduction of youth unemployment was launched with a budget of about one billion euros a year (Butterwegge, 2002). Some progress was also made in other fields, such as equal opportunities for women and assistance to handicapped persons (Kraske, 2002; Kulick, 2002). Other initiatives, however, like the reform of "mini-jobs" (jobs earning below 325 euros a month that are exempt from social contributions) and the attempts to reduce the so-called "pseudo self-employed" (*Scheinselbständigkeit)*, which were controversially and fiercely discussed in 1999 (see Mosebach's chapter on the welfare state in this book), in the end failed to have any major consequences. Neither a clear reduction of precarious jobs nor a significant improvement for those employees was reached (Kreutz, 2002; Kröger, 2002).

Together, these policies buttressed some core features of *Modell Deutschland*: First of all, the comparatively high level of employment protection and fringe benefits (*Lohnersatzleistungen*) – a stabilizing factor of labor relations and a central feature of the German production model – were reinforced. Second, these first steps marked a departure from the dismantling of the welfare state initiated under the previous government and could be seen as a confirmation of the (Keynesian) welfare state. Finally, despite the weak results, they were an attempt to revive corporatism and cooperative strategies of change.

The reversals of welfare cuts, the reinforced neo-corporatism, and the (Neo-) Keynesian macroeconomics did not go uncommented in the media, by opposition parties, or by business associations: For example, Hans Peter Stihl, president of the German Confederation of Trade and Industry (DIHT), complained about a "spirit of redistribution", and in the spring of 1999, Eric Gujer lamented in the *Neue Zürcher Zeitung*:

> "Though the SPD's election slogan of a 'New Center' was not merely a vote-getting trick, the party's so-called 'modernizers' are very much in the minority. Gerhard Schröder, who for a long time increased his own stature by distancing himself from other SPD leaders, has made it clear that he respects traditional Social Democratic policies and that they will provide the guidelines for his actions as chancellor. There has

> been no modernization within the SPD comparable to Britain's 'New Labour', and Schröder is making no moves to change that." (Gujer, 1999)

Lafontaine's economic policies met with stiff resistance from industry, which threatened to move jobs and operations out of Germany, and also failed to win the support of Chancellor Schröder:

> "[...] Lafontaine [...] has taken much of the blame for the 10 percent slump in the value of euro since it began life on Jan. 1. Confirming the economic importance of the change in Bonn, financial markets sent the euro sharply higher. [...] The Schroeder-Lafontaine conflict had escalated at an emotional closed-door cabinet meeting Wednesday night. Mr. Schroeder singled out Mr. Lafontaine as he lashed out at his cabinet, German newspapers reported. He blamed his Finance Minister for heaping new burdens on the power-generation industry just when the government was trying to extract an agreement to shut down nuclear power plants. [...] Evidence that Mr. Lafontaine had driven money out of Germany's economy appeared this week. A private bank in Lichtenstein, the V-P Privat Bank, announced that the 'Lafontaine effect' had sparked a flow of funds out of Germany and into its accounts, even allowing the bank to pay a special dividend." (Schmid, 1999)

According to the press and Lafontaine's later publication (Lafontaine, 1999), Chancellor Schröder did more than just attack Lafontaine inside the cabinet; he also launched press releases without previous coordination, accused Lafontaine of using erroneous figures, and repeatedly asserted his authority to establish policy guidelines.

A second turning point in this early phase of the red-green administration was the lost elections in Hesse on 7 February 1999 (mainly because of the poor showing of the Greens) to Roland Koch, the candidate of the Christian Democratic Union (CDU). For the left-leaning factions of both coalition parties, this defeat was twice as bitter. First, the lost majority in the upper house of parliament (*Bundesrat*) gave the conservative-liberal opposition the chance to block new acts and programs, in addition to strengthening the supply-side or pro-business line of the "Schröder faction". Second, the election results in Hesse signified a major blow to progressive ideas – especially those of the Greens – to modernize the German law on citizenship, that is the introduction of dual citizenship and the regulations on asylum and immigration. Koch's election strategy rested primarily upon a populist campaign against dual citizenship, which mobilized widespread xenophobic sentiments among the German population, and established this topic as a major menace for future election campaigns and as a lever to achieve concessions from the red-green coalition. Even the ensuing financial scandal (as well as further populist "slips" by Koch)[1] was not sufficient to seriously destabilize Koch's majority in Hesse and his rising prominence at the federal level: In 2000, Koch came under pressure through the so-called "black money" affair, in which the Hessian CDU transferred 20 million German marks to secret accounts in Swiss and Liechtenstein banks in the early 1980s. Part of the money was subsequently disguised as "Jewish bequests" and transferred back to CDU bank accounts in Germany – and was also used to finance the 1999 election campaign ("Leading Conservative", 2002).

> "When the Hesse scandal began to unfold, he [Koch] declared that he had not known about the secret accounts of his party. In early February [2000], however, he had to

admit that at least once he had lied to the public about his knowledge of the affair." (Nesshöver, 2000)

The "offensive" against the left-wing factions of the red-green administration and the "blunt hostility of nearly all global actors from Lombard to Wall Street and from Berlin to Frankfurt toward the project of Oskar Lafontaine" (Altvater & Mahnkopf, 1999, p. 530; translation: SB) reached a climax on 11 March 1999 with the resignation of Lafontaine after just 136 days in office. Even though Lafontaine was not only the traditional advocate of the working class but also, for example, collaborator on the drafts of supply-side or liberal tax reforms, his resignation was a very clear sign of the strong influence of capital and indicated the defeat of the "traditionalist" and Keynesian policies, respectively (Kreutz, 2002; Heise, 2002b). Under Oskar Lafontaine's successor in the finance ministry, Hans Eichel, the former premier of Hesse who had lost the elections to Roland Koch, supply-side tax policy and the goal of budgetary consolidation became the crux of the government's reform package.

Although the first two of the four pillars of the red-green tax reform (see also Mosebach's chapter on tax policies in this book), the reduction of income tax rates and the introduction of the "eco-tax", still corresponded with this early phase (cf. Hickel, 2000), there have also been compromises – not least reflecting the altered parliamentary majorities after the lost elections in Hesse. The income tax reforms (*Steuerentlastungsgesetz 1999* and the *Steuerentlastungsgesetz 1999/2000/2002*) reduced the tax burden of low-income households by lowering the initial rate of income tax (*Eingangssteuersatz)* and raising the basic tax-free allowance *(Grundfreibetrag)* step by step. However, the flip side of the coin was a reduction of the top rate of income tax (*Spitzensteuersatz),* which should (in part) be compensated by a rising upper limit of progression (*Progressionsgrenze)* and the abolition of tax exemptions. In subsequent years, after massive pressure from the business community and concessions in the *Bundesrat,* further reductions especially for high-income groups were added. While it is true that the tax burden was lessened for all households (as far as they are "allowed" to pay income taxes), the clear reduction of the top marginal tax rate meant that the relief was particularly great for high-income households (Schratzenstaller, 2002).

Also in 1999, the new energy taxes – a central feature of the Greens' program – were introduced. After massive protests by employers and threats to relocate jobs abroad, however, generous exceptions for energy-intensive branches were built in. Moreover, the tax revenues are not to be used to finance ecological investments (e.g. public transportation) but to reduce non-wage labor costs. In the end, it is at least doubtful whether any new jobs have been created, and the ecological effects have been modest and partly counterproductive (Hickel, 2000). By shifting the burden more heavily on low-income households, the eco-tax has achieved two-fold: its regressive effects have the potential of devouring the advantage of lower income taxes (Schumann, 2002), and it compensates employers twice, through lower corporate taxes and lower non-wage labor costs.[2]

3. FISCAL CONSOLIDATION AND THE PRIVATIZATION OF PENSIONS: THE EICHEL-RIESTER PHASE

After the resignation of Lafontaine and his staff, economic policies in the second, Eichel-Riester phase were dominated by four issues: budgetary consolidation, further tax cuts, pension reform, and labor market flexibilization.

The third pillar of the red-green tax reform was the reduction of corporate taxes. The business tax reform of 2000 aimed at improving international competitiveness and making Germany more attractive as a business location for foreign capital investors. The main results were the lowering and standardization of corporate income tax from 40% (withheld profits) and 30% (paid profits) to 25%, as well as several efforts to broaden the base of calculation (e.g. reduced possibilities of depreciation). Another important and, in the long run, perhaps momentous decision was the abolition of taxes on divestitures in 2002 (Schratzenstaller, 2002; see Kellermann's chapter in this book). Because of low tax revenues (as a consequence of Eichel's reforms) and the goal of consolidation, the advantages given to families – the fourth pillar of the tax reform – have been modest, for example, an increased child benefit, and the targets set by the Federal Constitutional Court will not be met before 2005 (Schumann, 2002). In the end, the winners have been "*Reiche* mit Kindern, nicht die *armen* Kinderreichen" ("rich people with children, not poor people with many children"; Butterwegge, 2002, p. 327).

As well as the reform of the health care system, the pension policy in Germany seems to be a never-ending story (see also Mosebach's chapter on the welfare state in this book). Because of demographic changes and high unemployment, the pension system has become increasingly mired in financial difficulties. Without higher immigration, the ratio of pensioners to the working population will continue to worsen. After postponing the reduction introduced by the former conservative-liberal government, the red-green coalition reduced payroll pension contributions to 19.5% in 1999, financed by the revenues from the eco-tax. Further reductions followed in 2000 (19.3%) and 2001 (19.1%), and in the long run (2030) the contributions should not rise above 22%.

Pensioners have also had to accept losses. First, in 2000, increases were reduced to the rate of inflation, and since 2001 they have been coupled again to the development of gross wages (minus pension contributions; and from 2010 on, only 90%). Thanks to a new calculation method, the pension rate itself should fall to "only" about 67% in 2030 (using the old method: 64%). A further reduction intended by Federal Labor Minister Riester failed because of pressure from the opposition and the trade unions (Auth, 2002).

In 2001, the Red-Green coalition introduced a new element into the German pension system. A privately financed and voluntary provision – the so-called *Riester Rente* – is to complement the statutory pension insurance, the traditional pension system based on solidary redistribution between the generations. This state-sponsored but individual provision, based on intertemporal capital market yields, is to compensate for the loss resulting from reduced pension rates and keep non-wage labor costs low. However, the introduction of a supplementary private pension system cannot solve (all) the problems. First, low-income households or persons who are most hit by the reduction in pension rates may not be able to afford a private provision. The consequence would be rising poverty among older people and rising inequality because of an even more marked prolongation of different employment and income opportunities (Auth, 2002). Second, because of the obvious risk of financial crisis, there is no guarantee that this diversification will also translate into more stability.

Beginning in 1999, the new “doctrine” – elaborated in the Schröder-Blair paper – of the red-green labor market and social policy came increasingly to the fore: *Fördern und Fordern* (incentives and demands).[3] The central ideas of this program, restricting welfare state benefits to only those with “real neediness” and linking benefits to stricter eligibility regulations, were not new. These ideas have always formed the basis of conservative and liberal social policy. What was new was the adaptation of these ideas by the Social Democrats and the invention of a “left supply-side policy” (Heise, 2002b; Butterwegge, 2002). According to the principle of “incentives and demands”, the strategy of individualizing the problem of unemployment (and hence indirectly the responsibility for being unemployed) and consequently intensifying the pressure on the unemployed already was part of the *Job-AQTIV-Gesetz* that took effect in 2001, which introduced, among other things, individual integration agreements (*Eingliederungsvereinbarungen*), the threat of freezing jobless benefits (*Sperrzeiten*), wage subsidies for employers, and a prolongation of temporary work. Under this law, labor market entry is moreover to be supported by the creation of low-income jobs, the direct or indirect subsidization of employers, and a reform of the unemployment agency (Deutscher Gewerkschaftsbund [DGB], 2001). Yet the result has not been more employment, but rather the (at least temporary) removal of many of the unemployed from the list of unemployment insurance recipients.

All in all, despite some improvements for labor, for example, in the case of codetermination through the reform of the Works Constitution Act (*Betriebsverfassungsgesetz*), the year 1999 bore witness to a significant turnaround from progressive to regressive steps in economic, social and labor market policy. This implied not only a shift of relative risk and financial burden from capital to labor (at least from a traditional Social Democratic point of view) but also a clear redirection of economic policies toward improving supply-side conditions and competitiveness.[4]

4. THE OMNIPRESENCE OF LABOR MARKET REFORMS AND WELFARE CUTS: THE HARTZ-CLEMENT PHASE

In the 1998 election campaign, the Social Democrats made the reduction of unemployment their top priority. Newly elected Chancellor Schröder went even further by linking the fate of the red-green government to its success in reaching this goal. At first glance, such behavior of the government may seem hazardous or, given its limited influence on several policies and their outcomes, even suicidal. Indeed, at the end of Schröder’s first term, unemployment stood at the same level as in 1998. Schröder was obviously under enormous pressure to demonstrate his resolve in fighting unemployment. He might have considered changing course and trying some of Lafontaine's macroeconomic prescriptions. Instead, he opted for more of the same medicine. In March 2002, he appointed a new commission chaired by an old friend, Volkswagen's personnel manager, Peter Hartz.

The Hartz Commission was composed of 15 persons representing major companies, consultancies, science, politics, business associations, and unions, who were to elaborate a reform proposal for the Federal Employment Office. Yet faced with persistent high unemployment and forthcoming elections, the mission of the Hartz Commission was soon widened to reforms affecting the entire labor market. In April 2002, long before the commission was scheduled to finish its work, Chancellor Schröder anticipated the outcome of the commission's report and announced for the next legislation period a redirection of labor market policy and the merger of unemployment assistance and social assistance, the so-called "Agenda 2010".

After public discussion about its anticipated content, and a month before the elections, the Hartz Commission's final report was presented on 16 August 2002 with great fanfare in the French Cathedral in Berlin. The commission boasted that its program, if implemented, would cut the number of jobless in half within three years. The report contained 13 "innovation modules", for example, the extension of temporary work, which implies a de facto neutralization of dismissal protection and a tightening of acceptability requirements, with the onus of proof resting squarely on the unemployed; eligibility criteria for unemployment assistance; the promotion of self-employment ("Me Inc."); and an efficiency-enhancing reform of the Federal Employment Office. Together with the promotion of mini-jobs and the subsidization of companies that hire long-term unemployed (*Job-Floater*), these measures not only would worsen the legal and financial position of (many of) the unemployed, but also would tend to establish a low-wage sector, partly by legalizing former moonlighting, particularly in personal services (for a critical assessment of the Hartz report, see e.g. Herr, 2002; Gerntke et al., 2002).

After its – very narrow – re-election in September 2002, the red-green government hurried to implement the Hartz reforms. For this purpose, Schröder replaced Walter Riester with the former premier of North Rhine-Westphalia, Wolfgang Clement, and united the ministries of economics and labor under his leadership. "Superminister" Clement broke down the Hartz proposals into four packages (Brütt, 2003; Dallmeyer & Stobbe, 2004):

(1) "Hartz I" entered into force on 1 January 2003 and introduced the "Personal Service Agencies" (PSAs) to place unemployed people in temporary work or loan employment. Furthermore, eligibility criteria and acceptability requirements (i.e. penalties for refusal to accept a job offer considered reasonable) have been tightened.

(2) "Hartz II" also entered into force on 1 January 2003 to foster independent ("Me Inc.") and low-wage (tax incentives for "mini-jobs" [up to 400 euros] and "midi-jobs" [up to 800 euros]) employment.

Additionally, employment offices have been restructured into "Job Centers".

(3) "Hartz III" came into effect on 1 January 2004 and provides the legal framework for the restructuring of the Federal Employment Office into the Federal Employment Agency.

(4) "Hartz IV" is intended to come into force in 2005, regulating the merger of the (reduced-rate) unemployment assistance and social assistance into the "Unemployment Benefit II" (entailing the reduction of unemployment assistance and the necessity of the long-term unemployed to accept every job offered), administrated by the Job Centers.

Besides the Hartz modules, further measures concerning labor market regulation were adopted in late 2003 and in 2004: a reduction of the unemployment benefit duration from a maximum of 32 months to 12 months for all unemployed; a repeal of dismissal protection for small businesses up to ten employees; the reduction of payroll taxes and social contributions on mini- and midi-jobs paying up to 800 euros per month, particularly in the household services sector; and a special program entitled for long-term unemployed in economically underdeveloped regions.

The labor market reforms, above all the Hartz concept, represent only one, albeit central, part of the Agenda 2010. In his government statement on 14 March 2003, Chancellor Schröder announced considerable cuts in the welfare system and since then – directed against the critics of the agenda in the red-green camp – has threatened to resign on several occasions in case the intended measures should fail. An entire reform package devoted to the *health care* system introduces several surcharges for medical services (e.g. hospital stays, medical practice visits, dentures, therapies) and medication, the abolition of reimbursements (e.g. driving costs), and the removal of several services and medications from the range of services defrayed by health insurers. Other non-insurance benefits, such as funeral allowances and one-off childbirth benefits, have been abolished. It is hoped – though it cannot be guaranteed – that these measures, as well as increased competition and privatization in the health care sector, will have a positive (i.e. lowering) effect on statutory health insurance contributions (see Mosebach's chapter on the welfare state in this book).

All in all, and at the latest since 2003, the "reform drive has accelerated enormously and reached an unprecedented pace in the final months of 2003" (Dallmeyer & Stobbe, 2004, p. 23). In addition to the measures cited above, the Agenda 2010 encompasses also a reform of the craft trades law and reforms of the educational system and measures to foster innovations. Besides the distributional effects and the lack of success (so far) concerning growth and unemployment, which are the object of academic debate as well as of recent social disputes, the (institutional) consequences of the red-green reforms for the German Model are less clear.

5. AN EXPLANATION FOR THE BEHAVIOR OF THE RED-GREEN COALITION

The shifts from "Lafontaine-Trittin" to "Eichel-Riester" and on to "Hartz-Clement" raise a number of questions. What needs to be explained first is the shift from a strengthening to a weakening of the institutional features of *Modell Deutschland*. *Riester-Rente*, corporate governance laws, and so forth, are neither the manifestation of an election-day mandate nor the realization of long-held beliefs of the parties in government. The electorate never called for any of these laws. In fact, neither party would have had majority support for these laws before coming to power (Heinrich et al., 2002, p. 39).

Second, it remains a mystery why, in the second, Eichel-Riester phase, despite the abandonment of the original agenda that favored the core constituency of the coalition government, some programs in the interest of this core constituency were nevertheless enacted. What needs to be explained is the combination of strategic decisions against, and small, incremental steps in favor of, previously held positions.

Third, the adoption of the unpopular Agenda 2010 remains puzzling, especially from hindsight. Why would a government turn against its core constituency at the risk of getting voted out of office?

So how did these strategic moves against *Modell Deutschland* come about? We believe that they were the outcome of structural *constraints* (not structural *determinations*) for a left-of-center party at a time when the social forces to the left of the political middle ground were on the defensive with respect to their mobilization capabilities and the intellectual attractiveness of their broad policy agenda.

Unlike François Mitterand's French Socialists in 1981, the red-green coalition was not bucking an international trend when it came to power. In France, the left-leaning coalition led by Mitterand assumed power following the conservative "revolution" in Great Britain and the United States and just a year before Helmut Kohl took over from Social Democrat Helmut Schmidt. By contrast, Schröder's victory came at the heels of the election successes of New Democrat Bill Clinton in the United States, New Labor Tony Blair in Great Britain, and Socialist Lionel Jospin in France. However, with the exception of Jospin, these leaders had embraced markets as solutions for social and economic problems, hence their emphasis on "new" in relation to their parties' traditional role as stalwart defenders of the welfare state.

The embracement of markets, and thus of private capital, by left-of-center parties reflected not only the reassertion of private business interests in Western societies but also the intellectual hegemony of market proponents. The appeal of markets, that is of private property holders in competition against each other, went far beyond the economic profession (see Beck's chapter in this book). It extended to public policy advisors and the media. The impressive job performance of the "New Economy" in the United States as well as job growth in the United Kingdom seemed to provide the empirical evidence for the theoretical assertion of neo-classical economists: namely, that deregulated markets were superior to the (allegedly) oversized welfare state (cf. Sturm, 2003, p. 90). Despite many well-founded alternative perspectives on the factors driving job growth in both countries (cf. Palley, 1998), the public debate focused almost solely on labor market flexibility (again, see Beck's chapter in this book).

At the same time, the discourse and practice of globalization drove home the point that competition among nations or, to be more precise, among specific sites of production, had become fiercer. This discourse on global competition furthered the acceptance of neo-liberal policy concepts, albeit for different reasons depending on the specific audience. Business and its political representatives spoke of globalization with a forked tongue. On the one hand, they extolled the virtues of globalization. This talk proved somewhat effective with those either successful in the international marketplace, that is young workers in the information technology sector, or shielded from international competition, that is professionals and especially journalists writing in German. It fostered the acceptance of markets among these groups. Many other Germans, however, were not so convinced of the benefits of globalization. Their reservations were not least a reaction to the other line of globalization talk by business (and by most politicians): using globalization to justify almost any attack on hard-won workers' entitlements (Krätke, 1997). The fear of job loss raised the willingness to forego protective rights. Overall, the discourse and practice of globalization increased the leverage of transnational corporations over workers and the welfare state.

At the same time, proponents of corporatist, statist solutions to globalization in general and unemployment in particular stayed on the defensive. Although most of them had not supported Soviet policies, the collapse of the Soviet Union discredited state intervention in the economy big time and took away a point of reference for arguing in favor of state planning (although the Soviet Union had ceased to function since the 1970s at least). In addition, the West's answer to the communist challenge, Keynesian policies, had been discredited by the inflation of the 1970s and their unsuccessful revival under the early Mitterand government. It all added up to a lack of a unifying vision beyond the defense of the status quo (Zeuner, 1998). Among many Green party members and leaders, the collusion of politicians and business in pursuit of nuclear energy had undermined their belief in the efficacy of the state for achieving progress. Many came to believe that under pure market conditions nuclear energy would have been abandoned long time ago (Volmer, 1998).

6. THE RATIONAL MOVE TO THE MIDDLE GROUND

Against this backdrop of a hegemony of neo-liberal ideas among policy elites, widespread feelings of job insecurity, and a lack of a clear alternative vision, the puzzles mentioned above can be solved by making use of context-sensitive rational choice arguments.

The argument starts out by recalling the simple truth that elections take place only every so often but politics are made every day. The victory at the election booth allows the winning coalition to occupy the top government positions but it does not guarantee the implementation of its policies (if it has any). Success is dependent on at least three other groups: the ministerial bureaucracy, interest groups, and the press. In Germany, only the highest tier of bureaucracy is replaced after a change of government. Policy expertise and – more importantly – expertise in policy processes rest with it (Schnapp, 2004). Let's take Lafontaine as a case in point: He received little support in his own finance ministry beyond the small team of policy experts he brought with him. In addition, he faced the opposition from the economics ministry, headed by Werner Müller, who was not a member of the Social Democrats.

The literature on policy communities tells us that the successful implementation of policies in a modern democracy depends ultimately on the cooperation of the strong "players" among the affected groups. This is all the more true for *Verhandlungsdemokratien*, that is neo-corporatist "negotiated democracies" (Esser & Schroeder, 1999). Lafontaine's agenda depended on the cooperation of the central bank, the *Bundesbank*, to lower interest rates, and on the finance ministries of other OECD countries to coordinate their fiscal policies as well as to prevent tax evasion. However, these partners were not forthcoming. In fact, the U.S. treasury did not hide its dislike for Lafontaine's Neokeynesianism. The German business community railed relentlessly against him (Hippler, 1999).

Finally, the press plays an important role at two stages in the policy process: in the deliberative phase and in the post-implementation phase. In the deliberative phase, unfavorable reporting can strengthen opposition to government policy among bureaucrats and interest groups. If the reporting portrays the government as inept, it may even affect the government's effectiveness in other policy areas. Lafontaine clearly suffered from unfavorable press. Successful implementation of government policies, if not made known, will help the parties in government little. Before the early red-green reforms had time to show any effectiveness, most of the press had already called for new, more market-oriented reforms.

The importance of the media leads to the next basic assumption of the overall argument: The coalition government wants to get reelected. In the public choice literature this is usually taken for granted. Politics, however, are not that simple. In the elections that brought the red-green coalition to power, Chancellor Kohl wanted to be reelected. But he was apparently not so interested in an election victory for his party, the Christian Democrats, because otherwise he would have prepared for a timely transition in leadership. Such a transition would have ended his career but might have kept the CDU in power (Langguth, 2001). Another instance of "irrational" behavior was the decision by Holger Börner, the one-time premier of Hessia, to throw Joschka Fischer and his Greens out of his cabinet in 1987. It was quite clear at the time that this move would not be honored at the election booth (Heptner, 2003). Whatever the motives for these moves were, individual politicians always find incentives to place personal gain over the interests of their own party. Interestingly, those politicians who pushed hardest for not-so-popular neo-liberal reforms and subsequently lost their elective office made a soft landing in the private sector. This is particularly true for Social Democrat Bodo Hombach, Schröder's first chief of staff, who was let go because of corruption charges. Later he rose to the position of CEO at a major news media company. The Green Oswald Metzger became a fellow at the Bertelsmann Foundation.

Each partner of a coalition government has strong incentives to pursue strategies at the expense of the other partner, endangering the coalition. In our case, the Greens had good reasons to move to the center. To the left of the SPD they would not find a partner strong enough to form a government. It was extremely unlikely that the post-communist Party of Democratic Socialism (PDS) would grow so strong as to become a serious contender for the chancellorship. Moving to the center, however, opens up the option for a new coalition with the CDU and thus increases the Greens' political leverage. This election calculus probably goes far in explaining the economic positions taken by the Greens in the last decade (Raschke, 2001). However, since the core constituency is not yet ready to support a black-green coalition, the party leaders do not have an incentive to distance themselves from their SPD coalition partner and risk endangering the coalition's overall chances to survive in government.

Unlike Kohl, Schröder is young enough in terms of both age (60 in 2004) and office to not have to think about leadership transition within the party. Thus, it is safe to assume that both coalition partners were interested in winning the elections in 2002 and want to win the upcoming elections in 2006.

Continuing our line of argument about "strategic choices", we can assume that the focus on reelection made the coalition partners desirous of being viewed as successful in government. Their primary audience was quite naturally those voters who had not voted for them the first time around and were therefore most likely to defect in the next elections. This non-core voters group can be divided into those who voted for the first time, former supporters who didn't bother to vote in previous elections, and those who switched their vote to other parties either to the left or right of the winning coalition. First-time voters have lost clout because of demographics. They are also no longer a distinct group relative to older voters in terms of their preferences (Hartenstein & Müller-Hilmer, 2002). The occasional voter and the voter from the left are frequently lost after the government's first years in office because their expectations are not met. The latter in particular are hard to please. However, they are not so numerous and more likely to become non-voters or be lost to marginal parties than to the main rivals. Voters from the right are not only more numerous (1,350,000 defected from the CDU/CSU to the SPD in 1998; Infratest dimap,1998)[5] but their defection also hurts more directly. In addition, they are more receptive to the arguments of the opposition and to other social forces that might oppose the government. This latter point was fully confirmed in the first state elections following the federal elections that brought the red-green coalition to power. Running on a platform against the Green's pet project of dual citizenship for immigrants, the Christian Democrats under Roland Koch pushed the red-green coalition out of office in the state of Hessia (Hofrichter & Westle, 2000). Hence, there are good reasons for a left-of-center government to listen to the voters to their right and to those who might have influence over them.

The alternative would be to mobilize one's own forces, to exhaust the reservoir of support within one's own camp. Left-of-center governments have seldom resorted to such a strategy (an exception was the SPD's mobilization before the "constructive vote of no confidence" [*Mißtrauensvotum*] against Willy Brandt in 1972; see also Burnham, 1980). Why have they hesitated to pursue this alternative? They might have wanted to avoid risking a profound alienation of the powers that be and a right-wing populist counter-mobilization. In addition, the social agenda of the left-of-center politicians has created a wide gulf between them and many in the original core constituency. Mobilization would entail representing some of the interests of those abstaining from elections, especially lower classes (for the USA, see Hicks & Swank, 1992; Hill & Leighley, 1996). Thanks to higher voter turnout than in the United States, mobilization might also be less effective in Germany (Oppenhuis, 1995).

To sum up, there are plenty of incentives for a left-of-center coalition to listen to the center and the powerful players in society who can influence the discourse on the effectiveness of the coalition in government. Yet this does not quite explain the difference between strategic and non-strategic decisions.

The next step in the argument focuses on the role of committed party supporters. Even the extremely commercialized American election campaigns rely heavily on volunteers (Thompson, 2004; Aldrich, 1995). In Germany, ordinary party members and activists in related organizations such as unions are pivotal in elections despite all the talk about media democracy. They have to appear convincing to their neighbors and others (though they might also be influenced by the media's portrayal of their party leadership; Schulz, 1998; Karp & Zolleis, 2003).

These members are active for their own electoral sake (e.g. as candidates at lower levels of the political system of representation), for the sake of political activities as such, for their interest in particular policies, or for general political beliefs (Heinrich et al., 2002). In a left-of-center party, a substantial number of these activists espouse positions to the left of the party leadership (unions, environment, Third World, gender, etc.), whereas in a right-of-center party, activists would most commonly be found to the right of the leadership (religious right, etc.).

According to a scientifically conducted poll in 1998, the average member of the SPD positioned himself slightly to the left of where he believed the whole party to be (ibid., p. 38). Why? Although there are many who like to root for the leadership, those who sustain a high activity level for an extended length of time are motivated by the belief that they are not adequately represented by their leadership. If they are consistently to the right of the leadership of a left-of-center party, they are likely to defect to the right-of-center party. Thus, for the most part, activists in a left-of-center party are more likely to be to the left of their party leadership (cf. Roemer, 1997; 2001).

As important as these activists are for winning the election, once in power, the leadership frequently considers them to be a nuisance or even a real threat to their ability to hold on to power. An example taken from American politics may illustrate this point (cf. Kuttner, 1988; Ferguson & Rogers, 1986). In the aftermath of the Carter administration, the Democratic Leadership Council (nomen est omen) intensively discussed the question of what to do with party members involved in social movements. One participant was Bill Clinton. After becoming president, Clinton pursued two strategies. One was the strategy of co-optation: he allowed the activists to assume minor posts. That this strategy is not sufficient was proven by the Carter experience. Once in government, activists will work for their own objectives and not necessarily for the President's reelection needs. Therefore, Clinton also made the following strategic move: Right at the beginning of his administration he began to espouse many progressive issues (e.g. gays in the military) that he had not taken up during the election campaign. The apparent purpose of this move was to demonstrate the viciousness of the opposing forces and, thus, to educate his overzealous supporters about the true balance of power. He quite masterly succeeded in silencing their criticism of his later rightward turn (e.g. welfare reform).[6]

Chancellor Schröder did not have to imitate Clinton on this account. He had others to do that for him: the Green minister for the environment, Jürgen Trittin, and Schröder's archrival and co-architect of his successful campaign, the Social Democratic party leader cum secretary of the treasury, Oskar Lafontaine. Taking their own leaf from the Machiavellian recipe booklet, both wanted to overrun the forces of the status quo: Trittin on the environmental front and Lafontaine on the social and economic front. They soon learned the hard way about the true balance of power independent of election days. Of the two, Trittin proved to be the more flexible character. He quickly learned to focus on incremental, administratively achieved progress (the Green's great project, the environmental tax, turned out to be a great tax exemption scam in favor of heavy polluters and a general subsidy for private sector employers; Berger, 1999). Lafontaine quit under mysterious circumstances, the reasons for which have yet to be disclosed to the public. However, the barrage of corporate and media criticism during his tenure in office is a fact (Bredthauer, 1999).

Lafontaine's replacement in the ministry, Hans Eichel, went swiftly about to placate his predecessor's main opponents: the U.S. treasury, the big corporations, and the media companies. On this account, Eichel was successful. The overt hostile criticism died down (Hippler, 1999). Why did Eichel go out of his way to keep the big corporations happy? Because big business is important to the SPD. While most of the small business owners are against the SPD anyway, big business has supported the SPD from time to time for strategic gains. It pursues a portfolio strategy for political access. Its tremendous monetary resources, as well as its intellectual capabilities and its sway over parts of the press, make it a power to reckon with, as Lafontaine had to learn the hard way (Lafontaine, 1999).

7. THE TRADE UNIONS' ACQUIESCENCE

Why didn't the unions mobilize against Eichel? They had been quite successful in opposing the Kohl government's cuts to the social safety net (35-hour week, sick pay, etc.). They could therefore have continued to mobilize their members to defend hard-won social entitlements.

Several factors kept the unions under constraint. First, the unions had been weakened during the 1990s. Some of their bargaining successes were won at the expense of strategic concessions, especially flexible handling of working hours at plant level and deviations from the central bargaining agreements. The effects of these concessions became more visible over time as a lot of works council members and union staff became absorbed in managing this new flexibility at the plant level. The de-industrialization of eastern Germany led to heavy membership losses and allowed many employers in this region to escape collective bargaining (Schroeder, 2000). Second, the general discursive shift away from solidaristic, state-centered approaches to social problems and toward market solutions put the whole labor movement increasingly on the defensive (cf. Fichter's and Klobes' chapters in this book).

With the incoming red-green government, a third obstacle to broad scale mobilization was added: The risk that this mobilization would alienate those non-core voters of the coalition and thus contribute to the coalition's failure in government. The SPD leadership was not shy about pointing out this risk. So the unions were caught in a dilemma: The red-green government was moving against them on important issues, but opposing these moves would make it even more likely that these detrimental laws would be enacted by the next conservative government (Zeuner, 2000). While the change of government afforded the unions access, their strategic leverage was lost. Earlier, the conservative government had to fear that moving too swiftly against the unions would strengthen the Social Democratic opposition. If the Social Democrats, having gained power, were voted out of office, an incoming conservative government might feel that it has a mandate and does not have to fear an immediate resurgence in popularity of the Social Democrats. This argument rests on the premise that not the absolute level of support is important but the dynamic of support. A party on the rise has more leverage than a party on the demise despite comparable absolute support in the voting population. The unions' dilemma was exacerbated by Lafontaine's fall from grace, which decapitated the socially progressive camp in the Social Democratic party.

A fourth reason for the unions going along with Eichel and the rest of the government was an especially clever insight into how to instrumentalize the *Riester-Rente* for their own purposes. If they could get the employers interested in a mutually run *Riester-Rente* scheme, they could create an incentive for union members as well as for employers to maintain centralized collective bargaining agreements (*Flächentarifverträge*). Members would get a better deal through this arrangement than on the open market, and employers would profit from lower pension contributions thanks to the economies of scale involved. The insertion of the *Riester Rente* into the collective bargaining agreements would, therefore, strengthen the collective bargaining agreements (Auth, 2002).

Finally, it is difficult for unions to mobilize around strategic government concessions to capital that are not immediately visible, such as tax loopholes, laws for corporate governance, and so on.

In sum, strategic moves such as the *Riester Rente* keep strong adversaries muted, while the negatively impacted constituency has a hard time mobilizing against these moves, not least because they are kept somewhat content through improved access to government.

8. THE HARTZ-CLEMENT PHASE

The turn toward more radical market-oriented labor market policies in the run-up to the 2002 elections can be readily understood in the light of the above argument. Given that the red-green government was very much behind its major campaign promise of 1998, that is to lower unemployment significantly, Chancellor Schröder had to act decisively. He might have tried to reflate the economy, but such a strategy would have run counter to Eichel's rhetoric of budget consolidation and the European Stability Act. In particular, reinflation would have alienated Schröder's friends in the media and in the corporate world. The trade unions might have cheered, but they had no alternative but to support his government. A more promising strategy would be one that would please the media and business while not alienating labor too much. Just such a strategy was pursued by asking Peter Hartz to head a commission of experts and representatives from important interest groups to work out solutions to unemployment. Peter Hartz was a perfect choice because he was the well-respected personnel director of Volkswagen (VW) – "Mr. Modell Deutschland" as it were. At VW, the personnel director is chosen after consultation with the union, the union is represented on the company's board, and the state of Niedersachsen is a major stockholder. Thus, Hartz was also acceptable to trade unionists. In contrast to *Bündnis für Arbeit*, whose members were appointed by participating corporatist interest groups, Schröder's office was able to pick and choose the commission's members from among the major interest groups and the ranks of experts. Some trade union members of the Hartz commission had reservations about the recommended policies, but they restrained from outright opposition. Schröder quickly capitalized on the commission's proposals and went public with Agenda 2010. He was thus able to present the public with an action program against unemployment, which was well received by the media and business organizations as it reflected their long-held views on the causes of the German malaise: labor market rigidities. Furthermore, he outsmarted the Christian Democratic opposition by co-opting their policy positions. In the few months left before the federal elections, the general public had little time to get acquainted with the details of the reform and the hardship it would entail.

After the elections, Schröder moved quickly to implement the Hartz reform, sensing a Machiavellian window of opportunity for reforms not particularly popular among his party's members and its constituency. The first major strategic move was to make Wolfgang Clement, the most neo-liberal of the Social Democratic heads of state governments, the "Super Minister" of the newly combined ministries of economics and labor. By stripping the labor ministry of its independence, Schröder eliminated bureaucratic opposition to his reforms within the cabinet. With a heavy hand and the threat of resignation, he brought the party behind his Hartz reforms. Up to this point, the moves of the Schröder government can be explained in terms of the above argument: rational behavior within the context of discursive hegemony of neo-liberal, market-oriented policy concepts. Conflict with the left wing of his party and temporary loss of popularity were to be expected; therefore, it made sense to pursue these strategies right at the beginning of the second term of the red-green coalition. However, popular discontent proved to be much more lasting and even increased as one reform after the other was enacted. While some of the sources of this discontent, especially the state of the world business cycle, were beyond the control of the Schröder government, others were the handiwork of the government. First, the repercussions of the early strategic moves to placate the business community had caught up with the red-green coalition. The finances of the municipalities, and hence local investment, dried up with devastating consequences for the job market (see Mosebach's chapter on tax reform in this book). Second, the most decisive and palpable cut in the welfare state, Hartz IV, was implemented a long time after the Machiavellian window of opportunity had closed, half way into the legislative term.

Staying the course of reforms after a series of lost elections amid spreading discontent does not fit well into our argument concerning rational behavior in politics. The determination to carry through with the reforms is even more astounding in light of the fact that Hartz IV will have its greatest impact in the former East Germany because of the higher degree of long-term unemployment and the previously higher rate of female labor participation. Thus, the red-green coalition attacks a region that was instrumental in its election victory in 2002. This no longer appears rational. We can only speculate about the reasons. Clement, who comes from one of the most western states in Germany, has never harbored sympathy for the East. Probably more important is the unwillingness to admit mistakes, in the hope the high-stakes gamble will pay off in the end. In a repeat of 2002, voters in 2006 might forget the Hartz episode and, with the help of a media blitz campaign on the eve of the elections, let the red-green coalition ride into their third term. However, by then all state governments might well be lost to the Christian Democrats, to the displeasure of local and state politicians of the Social Democrat Party. The Schröder government might also have miscalculated the unions' response. As long as Schröder seemed to be doing reasonably well at the polls, the unions did not want to contribute to his downfall. But now that the chancellor has lost the aura of a winning candidate, the unions have less to lose by resisting his policies. Furthermore, the new leadership of two of the major unions, the unions for the metal workers and the public employees, perceive the very survival of their organizations as meaningful political forces at risk ("Gewerkschaften streiten", 2004).

9. CONCLUSION

We started out by seeking an explanation for the three phases of the red-green reform agenda: starting with the Lafontaine-Trittin phase, which saw the implementation of long-held red-green policy ideas that strengthened core features of Modell Deutschland; moving on to the Eichel-Riester phase, which led to substantial tax relief for corporate Germany and a break with the principle of "parity" contributions to pension funds; and ending with the Hartz-Clement phase, during which the Agenda 2010 of massive cuts in the welfare system was developed and imposed.

We tried to show that the shifts from one phase to the other were the outcome of structural constraints on a left-of-center party at a time when the social forces to the left of the political middle ground are on the defensive with respect to their mobilization capabilities and the intellectual attractiveness of their broad policy agenda.

We placed the shift from Lafontaine-Trittin to Eichel-Riester in the framework of what to do with overzealous party activists once your party is in power. Both Lafontaine and Trittin were given free rein to pursue their pet projects, only to learn the hard way about the true balance of power independent of election days. Under Eichel-Riester, the powerful business and media groups were silenced by strategic moves in their favor, which proved to be measures against the social inclusion aspects of *Modell Deutschland*. The core constituency, especially the unions, were placated with small reforms and access to key government representatives, mainly within the framework of *Bündnis für Arbeit*. The shift to Hartz-Clement made sense in terms of electoral politics for a government that had failed to live up to its promise of improving the jobs situation. What remains a puzzle, however, is the determination to actually implement the unpopular Agenda 2010 despite successive state election losses and the prospect of losing the next federal elections.

In the end, the Schröder government seems to be falling victim to its strategy of aligning themselves with the powerful. This pact robs them of precious resources to lift their economic fortunes, pitting them against core constituencies, and therefore makes them expendable to their powerful partners in the end. Corporate interests will be served just as well if not better by a conservative government, which – at least for a while – would not have to fear Social Democratic competition in case of further cuts in the welfare state. Parallels with the former Christian Democratic prime minister of Spain, José María Aznar, and to Tony Blair of Great Britain come to mind. In the war against Iraq, both lined up with the lone superpower of the world, the USA, despite the strong opposition by the majority of their populations and of their parties. The one has already lost, the other awaits judgment at the election booth. In the case of Schröder, we will have to wait to see whether the commitment to eliminate major features of *Modell Deutschland* that buttress social consensus will win out over their will to win in the next elections.

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NOTES

[1] For example, in 2002 during a debate about federal government plans to reintroduce a tax for wealthy people in the state parliament, Koch compared the lot of rich people to that of Jews in Hitler's Germany ("Leading Conservative", 2002).

[2] The idea of a trade-off between higher energy costs/lower non-wage labor costs and employment (based on a Neoclassical production function) implies that this amount is not available for wage increases.

[3] The populist part of this strategy was the *Faulenzer-Debatte* (a public debate about putative lazybones among the unemployed) initiated by Chancellor Schröder and reinforced by Roland Koch, the Christian Democratic premier of Hesse (cf. "Die Faulenzer", 2001). The aim of this debate was to generate legitimacy for tightening the thumbscrews on the unemployed and for cuts in the welfare system.

[4] Even the lowering of the income taxes can hardly be called demand-side-oriented or Keynesian, because of the distributional effects of the reform.

[5] For a discussion on the increase of swing voters, see Falter et al., 2000.

[6] This interpretation is not shared by most commentators. However, since Clinton has been portrayed by the same commentators as extremely intelligent and since he has been aware of the problem since the early 1980s, we believe that he was capable of such a Machiavellian strategy (see Scherrer, 1993).

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Chapter 11

STEFAN BECK, FRANK KLOBES & CHRISTOPH SCHERRER

CONCLUSION

1. THE CHALLENGE OF THE GERMAN MODEL

The end of the competition between the capitalist and the socialist societal systems at the beginning of the 1990s marked a turning point for capitalist development in the post-war period. On the one hand, the hegemony of capitalist economies in general and the neo-liberal U.S. economy in particular experienced a new renaissance. On the other, the competition *between* different capitalist systems increased and the (West) German Model suddenly lost its role as a showcase of capitalist achievements and with that much of its support. Moreover, the comparatively long-lasting *New Economy* boom, propelled by huge capital inflows and massive investments in information technologies, seemed to manifest the superiority of the Anglo-American model of capitalism in the new age of globalization.

In contrast to this success story of the U.S. economy, the German economy has been plagued by slow growth and high unemployment for more than a decade. Consequently, it is no surprise that shifting political and economic conditions in the course of European integration, German reunification, changes in global production systems and demography all give cause to questions about the future of the German Model. Indeed, the welfare state, industrial relations, and the peculiar intertwinement of financial and industrial capital are currently experiencing a comprehensive change based on economic restructuring and socio-political reforms.

However, if one takes a closer look at institutional change, economic performance and (public as well as academic) discourse about both, then the picture of the German economy becomes more and more confusing. While there is a discussion about an alleged incrustation of the German Model, significant institutional changes and considerable adaptability can be observed. And while there is much lamentation about a decline of the German economy in global competition, Germany is rushing from one export record to the next – even excelling the much larger U.S. economy in absolute figures. So, is Germany a contender on the way out or a secret champion? There is no doubt that the German economy is ailing in terms of economic growth and unemployment. But what's the use of knowing this? And even more important, *how* is this fact used or explained? Is a lack of institutional,

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particularly labor market, flexibility and of competitiveness responsible for these problems? In the dominant view, this latter question is redundant because lack of flexibility and competitiveness *is* the problem.

According to our assessment, this view is too hasty. From a heterodox (economic) as well as from a non-positivist point of view, it is important to look behind the common certainties. First of all, it is useful to look for alternative explanations for the enduring macroeconomic weakness. Secondly, there is plenty of evidence that gives reason to question the thesis of a competitive backlog due to structural or institutional incrustration. Finally, we do not believe it is possible to isolate existing – or supposed – phenomena from the perceptions and discourses relating to them. Neither interpretations nor the phenomena themselves are objective or detached from discursive power. An assessment of the constancy of the German Model is therefore necessarily built on competing interpretations of its institutional and socioeconomic strength, possible deficits and the relevance of internal and external dynamics.

In the preceding chapters, the authors have discussed various aspects of the German Model with regard to their internal and external dynamics. They all endeavored to detect current challenges, which are discussed in the context of globalization, and their impact on the German Model, either as a consequence or as a (putative) requirement to adjust. As the various chapters show, however, the question of *surviving globalization* is a twofold one: *Empirically,* it is about current trends and changes in the institutional configuration of the German Model, its mode of coordination, and the – stabilizing or undermining – strategic about-faces of its actors. Are fundamental changes, cracks, or even departures from the model identifiable? *Theoretically*, the question is about the socioeconomic strengths and the weaknesses of institutions and actors coping with or adapting to these challenges. Both questions are complicated. While the latter depends on the theoretical point of view, the former requires the identification of core or constitutive characteristics of the German Model and an assessment of current changes with regard to them. Moreover, incremental changes – perhaps seen as modulations along a followed path – can add up to fundamental changes comparable to perceptible breaks. Finally, as the discussion of the German labor market and of the continued efforts to improve competitiveness shows, neither question must correlate with the other, that is institutional change or pursued reforms, for example, must not be advantageous or reflect a real need for change.

Nevertheless, considering the findings of the preceding chapters, in this concluding chapter we want to discuss these questions with special regard to three selected features of the German Model:

(5) the democratic inclusion of actors or groups, that is the availability of the *voice* option,

(6) the social and material inclusion and the involvement of different groups or persons,

(7) the economic orientation toward the world market, reflected in export surpluses and the high competitiveness of a diversified quality production.

In accordance with these features and the corporatist tradition, we believe that at the core of the German Model are those institutional and habitual factors that foreclose exit options for the main societal actors in their relations to one another and thus force them into constant dialogue and negotiations. Therefore, not only a decreasing social inclusion or democratic participation, but also an unclosing of exit options and their increased use by economically strong actors would restrict or even undermine the capacities of the German Model. On the other hand, however, change must not always mean erosion. For example, unification, that is the accession of East Germany was, first of all, an expansion of West German institutions. Besides Germany's unification, in the following sections we will focus on the consequences of economic and industrial restructuring in the context of globalization, European integration, and the reactions and reform activities of the red-green government. In the last section, we will confront changes, cracks, and instances of continuance with respect to Germany's mercantilism – perhaps the most obvious line of continuity.

2. EVASION OF THE GERMAN MODEL?

German industry is still based on the dominance of large companies, a strong export orientation and an educational system of highly skilled workers. The trend toward the service sector continues but is slower in Germany than in other countries and bears the German Model's characteristic preponderance of industry-related services. Nevertheless, processes of globalization and corporate restructuring have seriously affected the German economy, and many jobs have been lost or transferred to suppliers and contract manufacturers.

The process of industrial restructuring caused by increased international competition was further intensified by digital technologies. The latter are both a driving force and a managerial instrument in the internationalization of companies. Less integrated, focal companies are increasingly unwilling to bear the risks of capital investments and production fluctuations and are barely able to meet the requirements of production flexibility. They focus instead on their core competences, particularly on product development. Consequently, focal companies manage the disintegration of the value-added chain through outsourcing and even through selling entire production sites to so-called "turnkey manufacturers". The disintegrated processes along the more complex value-added chains are re-integrated via digital platforms. Furthermore, mergers and acquisitions, cooperations, new investments and also outsourcing have led to the constant creation and expansion of internal and inter-company networks worldwide. Despite retarding forces, which are rooted in the established production structure, product characteristics, and in the countervailing power of trade unions, these developments are particularly visible in the German technology and automotive sectors in the form of operating company models.

In view of disintegrating production chains and creation of complex company networks, management is faced with the task of controlling such complex company structures. The result of new controlling methods adapted to network structures is a transition from direct and directive hierarchical company control toward indirect control by introducing internal competition and the use of new communication processes based on a socio-integrative coordination mechanism.

Intensified competition at all corporate levels – on the shop floor, between cost centers, business units and different plants – results in global competition reaching every part and employee of the company and consequently exerting pressure on the German Model of industrial relations and codetermination. Additionally, the internalization of production processes and the increasing cross-national mobility of capital broadens the exit options of many corporations and enables employers to put pressure on codetermination and collective bargaining agreements at home. While the works councils of big companies have already changed policies and their self-conception, from being a protector of workers' rights to being a formative corporate power, trade unions often meet this pressure for change with special sectoral bargaining contracts and the concession of opening clauses at the company level. These shifts in the power relations between capital and labor and between works councils and unions, however, tend to undermine the protective as well as the balancing functions of German industrial relations. Especially in sectors or companies with a low degree of organized labor and consequently weaker works councils, the pressure on wages and working conditions is increasing. As a result of these developments, the differences between wages and working conditions have become greater, the number of employees excluded from the material and participatory advantages of organized labor increases, as does the heterogeneity and segmentation of the working class.

Another institutional, tradition-bucking trend can be observed in the area of company controlling, which is founded on the interrelation between new management strategies, production concepts, and a stronger capital market orientation of big companies. Since the 1990s, a far-reaching process of disintegration of Germany's traditional entanglement (i.e. mutual ownership and long-term credit relationships) of banks and industry has been taking place. The global financial market, in line with prevailing Anglo-American practices, has pressured *Deutschland AG* to liberalize its corporate governance institutions in two ways: On the one hand, the orientation of large private banks toward investment banking implies a reduction in ownership of industrial equity. On the other hand, with the liberalization of international capital markets, businesses can increasingly raise money directly on capital markets and thus release themselves from credit-induced dependence on particular financial institutions. The growing importance of capital markets and intensified international competition among institutional investors is now leading to a *shareholder value* orientation, which means a predominant interest in the short-term increase of companies' value. This orientation to the interests of shareholders will gain further weight for several reasons: For one, the institutional anchoring of investment banking creates financial actors who seek to split or restructure companies with a view to higher share prices. A second reason is that to utilize the low-cost, international supply of capital requires enhanced company transparency with respect to investors who cannot draw on banks' insider information. Finally, shareholder value orientation is flanked and driven forwards by political legislation initiatives concerning corporate takeovers, in particular through tax reductions on proceeds from the divestiture of assets. These tax reductions, however, are not only a further form of tax relief, but also a measure to accelerate the decartelization of the German economy.

In the end, *Deutschland AG* threatens to falter at the weak point between mutual capital holdings and credit relations. Additionally, encouraged by the transition toward private, capital-backed old-age provisions, an all-finance concept becomes more attractive. This concept extends the old principle of all-purpose banks to insurance services and also entails multi-specialization in the most profitable businesses. Furthermore, the resulting concentration in the financial sector – as well as in other sectors – is accelerated through the homogenization of European markets. The deregulation policy of the European Commission promotes privatization and liberalization, particularly in the service sector. The Commission's policy is directed to break up national monopolies and to restrict governmental opportunities to influence economic development, for example, by subsidies. By this means enterprises experience increasing competitive pressure and consequently intensify their merger and acquisition activities. This process of concentration on the European scale is additionally supported by the industrial policy bias of the competition rules, which boost merger activities of European enterprises. Moreover, with the statute of stock corporations, basic conditions for cross-border merger activities and the creation of European enterprises are enhanced. The increasing number of cross- or transnational enterprises, however, will also be less committed to the German location and its institutional regulation.

All in all, the insertion of Anglo-Saxon features into the German Model reflects a general shift toward market solutions and away from corporatist approaches to socioeconomic regulation. The competition-driven company control through the shareholder value principle supplants the German Model's characteristic stakeholder orientation, where codetermination both at the supervisory board level and on the basis of the labor-management relations act constitutes a decisive regulating factor. As a consequence, the pressure on codetermination increases further. In the course of global industrial restructuring and the reorientation of corporate governance, the German Model's unique negotiating system is being broken up, and the negotiating position of nationally anchored trade unions is weakened. Under the pressure of intensified global competition and European liberalization, the system of collective bargaining agreements begins to erode.

The tendencies toward a decentralization of collective bargaining, made evident by opening clauses, the practice of "regime shopping", and the flight from membership in the employers' association and from collective contracts, not only further the heterogeneity of social and material employment standards but also jeopardize the regulatory capacities of the German system of industrial relations. Apart from taking wages out of competition, the system's function was also to ensure labor peace and to encourage firms to adopt high standards – technology, quality, productivity, employment security, and so forth – using highly skilled and well-paid employees. Social segmentation and an increasing exclusiveness of high standards are therefore only the distributive side of a menacing erosion of collective bargaining. The other side could be a failure of the economic steering function of collective bargaining agreements and codetermination, which has been considered by many observers as an important pillar of diversified quality production and therewith Germany's high competitiveness and economic success.

Until now it is not clear to what extent the processes of deregulation and decentralization will lead to an erosion of the present German Model of industrial relations, because the future course of change depends on the strategies and power of the organized actors involved. Recent moves of both employers and government, however, signalize a declining confidence in collective regulations and standards. Increasing competitive pressure due to macroeconomic stagnation has induced more and more small and medium-sized enterprises, especially in eastern Germany, to renege on or evade collective agreements. Also, current labor market reforms encourage the creation – partly by substituting regular employment – of atypical, low-wage and less protected employment. Maybe more important are, however, two recent thrusts: firstly, the political and academic debate to lower wage and employment standards generally in eastern Germany as a measure to revitalize the economy of the new *Bundesländer*, and secondly, the attempts of big, internationally successful corporations in the automotive industry to lower collective wages and employment standards even for their core labor forces. Until now, public indignation retarded the latter thrusts, but when the dismantling of (long struggled for) standards even reaches the core labor forces of big companies in the privileged export sectors – which have been the props and the main beneficiaries of the German Model of industrial relations and mercantilism so far – then perhaps the days of the model will be numbered.

3. RENOVATION OR DEFORMATION OF THE GERMAN MODEL?

In 1998 the red-green coalition took office with the announcement of a socioeconomic and institutional renewal of Germany. The assertion to reconcile economic and financial requirements with social justice encouraged many voters' hopes for mastering the challenges of globalization and regaining macroeconomic success without dismantling the achievements of (material and democratic) participation and the German welfare state. Since this combination – economic success, codetermination and social welfare – was exactly the appreciated success formula of the German Model for many years, recent red-green reforms have to be assessed discerningly. Taking the announcement seriously, one could have expected a cautious, path-following adjustment of the German Model, relying on the peculiarities and comparative advantages of the model. By way of contrast, the cutting of basic institutions could endanger the functionality of an existing model, which was particularly successful concerning the pursued goals, in favor of an (at best) unknown outcome or a model, which is, despite its merits, inferior in this regard, as experience shows. Accordingly, our interest here is to look for "strategic" decisions of the red-green government, which could have an enduring, that is altering or even dismantling, impact on existing institutional peculiarities and therefore could create new path dependencies for the future of the German Model.

After six years the interim balance sheet of the red-green government shows moderate results. With regard to its main goals, reducing mass unemployment and fiscal consolidation, the success was at best modest. However, reproaches of inertia or even a derogation of Germany's international competitive position are unwarranted. Measured by the concept of the "Third Way", the red-green coalition has implemented many items and initiated fundamental reforms.

The red-green fiscal and tax policy had set itself the goals of enhancing the international competitiveness of German firms, reducing public indebtedness, and spurring economic growth by disburdening private, in particular low-income, households and attracting foreign investment. The reform of corporate and income taxes implied a sustained decline in capital taxation, and especially big corporations, already the most mobile actors, are given more and more tax relief or further exit options. Germany – far from being a high-tax country – now has the second lowest implicit tax rates for capital among the 15 "old" member states of the European Union. However, the various reductions of corporate taxes could also trigger tax-cutting competition in the European region.

But, contrary to the expectations of many, tax cuts have not yet led to higher growth rates. Not only has the (proportionally smaller) relief of low-income households been devoured by other social and financial burdens, but also, amid an economic slowdown, German financial policy has had pro-cyclical effects owing to efforts to meet the criteria of the European Growth and Stability Pact. As a consequence of reduced tax revenues and fiscal austerity, in particular the public investments of municipalities have declined sharply, and more and more public services – an important feature of the German Model – have become an object of economy measures. Meanwhile, the traditional Social Democratic goal of more social justice seems to have moved far away, and generally there's a danger that the interplay of tax cuts, debt reduction, and a lack of international tax cooperation will severely limit the capacity to provide public goods.

Not only concerning public expenditures and macroeconomic steering policies, but also with regard to the welfare state and labor market policy, the red-green government has – at least after Oskar Lafontaine was put to flight – widely submitted itself to the dominant conceptions of supply-side or neo-classical economics. Accordingly, the phenomenon of mass unemployment has to be tackled essentially on the labor market. The underlying conceptual link between economic policy and welfare state restructuring is to prevent the ancillary wage costs (i.e. the social insurance contributions) from rising. Especially the *Agenda 2010* followed that road of social policy reform by introducing comprehensive measures to restructure the German welfare state.

One of the most obvious strategic decisions of the red-green government was the establishment of state-subsidized, additional private pension funds. The guiding objective thereby was to limit the contribution rate to a maximum of 22% of wage earner's income in 2030. For several reasons this reform marked a paradigm shift in pension policy: Firstly, despite several improvements for caregiving parents and women, in the face of mass unemployment and new forms of (low-wage) labor, the standard of living will no longer be guaranteed. Secondly, the additional financial burden for employees in the form of private pension provisions signifies a departure from the path of equal financing. Not least, the introduction of market-style modes of regulation into the welfare state weakens the principle of solidarity redistribution in the German social order, which is increasingly supplanted by the theme of individual responsibility now.

In health care, the red-green government failed to give managed competition – jointly introduced by the Christian and Social Democrats into the health care system in the early 1990s – a more Social Democratic face. In 1999 it first repealed some privatization measures of the former conservative-liberal government. But, ironically, the recent health care reform act reestablished many of these privatization measures. The reinstituted higher co-payments and the shrinking of the health care benefit package contradict the solidarity principle of the statutory health insurance, returning to the conservative-liberal way of health care financing reform of the late 1990s. Although the red-green government has tried to foster the implementation of managed care in health care service provision, it has also followed the path of the conservative-liberal government. At least broader patients' rights have been introduced for the first time, but the effects of these measures remain to be seen. A further paradigm shift in German social policy would be the upcoming health care financing reform. Both a citizen's insurance and a capitation premium would alter the shape of statutory health insurance fundamentally, by either enlarging or undermining its solidarity aspects.

Since the German welfare state still depends on labor market developments, a macroeconomic revival and the creation of new jobs remains a premise for the financial stabilization of the social insurance system. However, neither the macroeconomic course nor the recent labor market reforms of the red-green coalition will likely create a huge number of new jobs. A labor market policy based on the creation of low-income jobs, a *(neo)mercantilist* wage policy, and rising individual competition is more likely to lead to a worsening of the income basis of the social security system and many households. Apart from the fact that there is a lack of employment opportunities, particularly for older persons, the long years of paying contributions and the fact that often *firms* have tried to "get rid of" senior employees are ignored. Under these circumstances, the social insurance system can neither safeguard a reasonable standard of living in old age nor guarantee equal and universal access to health care services. In fact, the strategy to lower ancillary wage costs by welfare state restructuring and flexibilization of the workforce has already undermined the social foundations of the German welfare state and heightens the tensions among and between the organized actors of German corporatism.

Although the basic institutions of the social insurance system still exist formally, the ongoing transformation from "welfare" to "workfare" according to the principle of "incentives and demands" gradually converts the German welfare state from a solidarity system of warranted rights into an individualized system of conditional granting bound to the coercion to take up work. In particular, the creation of a significant low-wage sector seems to be irreversible and ultimately increases the (destructive) pressure on the average wage level, collective bargaining and on welfare payments (i.e. the reservation wage). Moreover, the microeconomic logic that drives current reforms, favors an extension and deepening of this reform trend and similar institutional alterations, even if success stays away. It is therefore no surprise that the suggestions or demands for more far-reaching reforms and attacks on the German Model (e.g. the abolition of centralized wage bargaining, further welfare cuts, eastern Germany as a low-wage area) become more serious.

4. THE GERMAN MODEL AT THE CROSSROADS

Another important characteristic and a constant factor of the German Model was the world market orientation of (not only big) corporations and societal actors. For more than forty years, the German economy has generated a trade surplus and, with few exceptions, also a current account surplus. The preservation of trade surpluses can be considered a primacy of German economic policy, although this has come at the expense of other goals. Besides a tight, stability-oriented monetary policy and fiscal discipline, the cooperative relations between capital and labor have been the main political and institutional reason for reaching this objective. While the former assured low inflation, the latter provided moderate wage increases, a low strike rate, and high rates of productivity. The institutional framework of labor relations therefore not only served for distributional and protective purposes, but also proved to be a constitutive and promoting element of Germany's diversified quality production. Indeed, there was an unwritten productivity coalition and consensus to ensure international competitiveness, high quality, and high employment standards.

Despite all political and institutional changes, this kind of mercantilism still prevails today. After a short period characterized by the import surge in eastern Germany in the wake of reunification, the German economy soon returned to a current account surplus at the beginning of the new century and, in 2003 and 2004, even obtained new export records. This recent success was both the result of industrial restructuring processes in the 1990s and an increasing competitive advantage concerning unit labor costs and a comparatively low inflation rate in recent years. But even this remarkable development has not caused a macroeconomic revival and a reduction of unemployment. Although many had expected higher growth rates, this divergence of (booming) exports and (sluggish) growth came as no surprise. Already in the 1970s, the conjunction of mercantilism, high growth rates and full employment had begun to break apart owing to the counteractive effects of the mercantilist strategy itself and an altered international politico-economic environment after the abandonment of the Bretton Woods regime.

Insisting on the idea, however, that trade surpluses would quasi automatically induce growth and employment, the way out of macroeconomic stagnation is commonly seen to lie in a further increase of competitiveness and exports. Theoretically, this view is backed by mainstream economists, who don't get tired of arguing that Germany's weakness is the result of regulations reducing competitiveness, in particular high wages, high employment and welfare standards, and a lack of labor market flexibility. Meanwhile, the notion of competitiveness seems to have taken on a life of its own, such that nearly all other institutions and policies are subordinated to this objective: the welfare state, labor market policy, education, labor relations, and so forth. The perceptions of globalization or global competition – beyond all "real" processes – thus come in handy, delivering after all the vindication for "necessary reforms".

What is not told, however, is how an alleged lack of competitiveness can coexist with record export surpluses and what the price is for achieving those records. Indeed, a closer look shows that Germany's problem is not a lack of competitiveness, but rather seems to be the consequence of subjecting the domestic economy to a mercantilist strategy whose macroeconomic yield vanished long ago. According to this assessment, current German – but also European – policies and reforms are anything but inevitable.

This means there are at least two fundamental alternatives. The first would be going ahead with the adopted strategy of welfare and labor market reforms, the deregulation and flexibilization of labor relations, a tight monetary policy, and fiscal austerity – all in the name of international competitiveness. Perhaps growth and jobs will come back some day. The risks of this strategy, however, should not be underestimated. Since the mercantilist strategy furthers exports at the expense of domestic growth dynamics, the negative effects may prevail. As the past years show, the dismantling of welfare state provisions or wage concessions does not ensure more growth and employment. Additionally, Germany would force the smaller European economies to follow suit, with the consequence of a further contraction of European demand. On the other hand, an even more rigorous pursuance of this strategy would mean a further abandonment of social and participatory achievements of the German Model and would put its underlying societal consensus at risk. Moreover, the deregulation of industrial relations and employment standards, in particular a possible erosion of collective bargaining and the alienation of codetermination, could undermine the so-called *Produktivitätspakt* and therewith the foundation of Germany's diversified quality production and its export success. The consequence would be not only the destruction of the German Model but also an erosion of its economic strength. Then Germany would *really* enter (low) wage competition.

The alternative – apart from doing nothing – may be more promising economically, but very difficult to enforce politically. Contrary to the prevailing consensus among societal and business elites, mainstream economists, and major factions of the popular parties, such a strategy would imply an abandonment of Germany's mercantilism in favor of a strengthening of internal growth dynamics (e.g. public investments and private demand), a less austere, but rather anti-cyclical fiscal policy, and a broadening of the tax base. Moreover, such a strategy would have to be embedded in a coordinated European macroeconomic policy, comprising monetary as well as wage policy, a containment of international tax competition and tax avoidance, and a revision of the European Growth and Stability Pact. For such a strategy the dismantling of welfare provisions and public services or a social and material exclusion of large segments of society would be counterproductive, as would growing disparities between regions and income classes.

At present, the latter alternative seems remote. In the predominant academic and political debate, the theses of competitiveness and flexibility knock out all contending arguments, and in systemic competition the market-style, Anglo-Saxon type of capitalism is deemed to be more suitable for coping with the challenges of globalization. Political initiatives for international taxation of capital income, for example, are as deadlocked as a reformulation of European economic and monetary policies. Therefore, a further deregulation of the German Model and its interspersion with market-style modes of regulation seems to be more likely. However, the political and societal tensions would probably rise as recent protests in East Germany against the current labor market reforms (*Hartz IV*) and the *Agenda 2010* show. Moreover, following the current path, the alignment of socioeconomic conditions between East and West Germany may perhaps end up being an alignment of the West to the East, and not vice versa. What then might follow politically and economically is an open question.

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