

From stability to stagnation: Germany at the beginning of the twenty-first century

Streeck, Wolfgang; Kitschelt, Herbert

Veröffentlichungsversion / Published Version

Sammelwerksbeitrag / collection article

Zur Verfügung gestellt in Kooperation mit / provided in cooperation with:

SSG Sozialwissenschaften, USB Köln

Empfohlene Zitierung / Suggested Citation:

Streeck, W., & Kitschelt, H. (2003). From stability to stagnation: Germany at the beginning of the twenty-first century. In W. Streeck, & H. Kitschelt (Eds.), *Germany: beyond the stable state* (pp. 1-34). London: Cass. <https://nbn-resolving.org/urn:nbn:de:0168-ssoar-195077>

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From Stability to Stagnation: Germany at the Beginning of the Twenty-First Century

HERBERT KITSCHOLT and
WOLFGANG STREECK

Among political and economic elites as well as in public opinion a sense of malaise has spread across Germany since the mid-1990s, after the initial enthusiasm about German unification, the end of the Cold War and the acceleration of European integration. In the early 1980s West Germany was widely celebrated, and indeed celebrated itself, as an island of economic prosperity, social peace and political stability in an increasingly turbulent world. Reflecting the opinion of the time, *West European Politics* published a Special Issue in 1981 under the title of *Germany: Perspectives on a Stable State*. During the 1970s and early 1980s, when the United States was in a deep crisis of economic performance and public confidence, the German industrial strategy of ‘diversified quality production’ became an admired model world-wide, echoing Helmut Schmidt’s proclamation of *Modell Deutschland* in his first election campaign of 1976 when he prided himself on his government’s achievement of apparently unshakeable tripartite consensus with business and labour.

Two decades later, German political and social institutions and the policies they support still look very much like the 1980s. But now suspicions are rampant, inside Germany as much as outside, that political and institutional stability may no longer be an asset. Dramatically declining economic performance has raised the question whether Germany can cope with the economic, demographic and cultural challenges of a new century. Indeed as the contributions to this volume show, a case can be made that the same institutions that once provided for economic prosperity and social cohesion today impede adjustment and stand in the way of a sustainable response to new problems. Germany (and this in fact is the argument we will develop in this introduction) appears to be stuck in a ‘high equilibrium trap’ – a situation in which the institutional and cultural legacies of a successful past shape the actors’ interpretations of self-interest and of feasible strategies, as well as the choices available to them, in such a way as

to prevent them from doing what they would otherwise have to do in order to improve economic outcomes.

Until the September 2002 federal election, German political elites and mass publics had not yet reached the point where the symptoms of the crisis had become sufficiently painful to make the cost of profound change appear lower than the losses incurred by continued muddling through. Just as in Japan, citizens have been losing confidence in the political elites, but they do not see better alternatives. In both countries, the odd spectacle unfolds of governing parties becoming unpopular without a viable opposition emerging (Japan) or an existing opposition being able to benefit (Germany).¹ Given Germany's painfully slow, incremental process of political and economic change, for some time there is likely to be a growing gap between rapid problem accumulation and slow problem-solving in existing political and economic institutions.

The task of this volume is not to speculate about the duration of the crisis, let alone the nature of its outcomes, but to contribute to the analysis of its origins and current dynamics. This introduction sets out the theme by briefly going over the nature and origins of the 'German system'. We then provide some empirical evidence for that system's diminishing economic performance in the subsequent decade and discuss some of the institutional factors that have stood in the way of a successful defence against decline. Following this, we investigate why there is little hope for the German political system to overcome its present immobility, making continued social and economic decline the most likely scenario for the future. Finally, we address, in a general way, what a German recovery would require and what political configurations might conceivably bring about real change.

VIRTU AND FORTUNA: WHAT MADE THE GERMAN SYSTEM WORK?

The post-war German political economy, as it came into its own in the early 1980s, consisted of a unique configuration of institutional mechanisms to co-ordinate capital, labour and public authority. Many elements of this configuration already existed in the early years of industrialisation, while others evolved only after World War II.² Together, the institutions that later seemed to compose a coherent 'German model' performed exceedingly well in the global political-economic context of the 'Golden Age' of post-war economic recovery and, particularly, increasing international trade, allowing West Germany superior economic performance in comparison to other advanced capitalist countries. They also supported a remarkably successful adjustment to the era of declining mass production in the 1970s

and 1980s when Germany, just as Japan, managed to steer clear of the Fordist production model much faster than other countries, including especially the United States.³

This is not to say, however, that German institutions as they existed in the 1970s and 1980s were consciously designed to match the economic challenges of their time. From the 1960s to the late 1980s, their economic virtue was more discovered than planned. To paraphrase Machiavelli, it was to a large extent conditional on good fortune: on favourable external circumstances whose contingent requirements the German political economy happened to meet better than the institutions of other countries. If only for the heterogeneity of its origins, the German political-economic system could never, not even in its economic heyday, be explained as a product of self-interested actors designing institutional arrangements for purposes of economic and political efficiency. A functionalist logic that does not recognise historical contingency cannot explain the emergence of a web of institutions, even if it has beneficial consequences for almost all actors operating under it and contributing to its modification.

Nor can a functionalist logic be relied upon to provide a new institutional design when a formerly successful system experiences a crisis due to changing external conditions. The problem in such moments is not one of inventing another, better adjusted coherent system to be put in the place of the old one. Rather it is to develop and make use of a political capacity for practical experimentation and serendipitous innovation by which to discover new niches for a political economy's distinct capabilities in its evolving environment. Therefore, the reason we believe Germany to be in a severe crisis is not primarily that its economic institutions no longer match contingent conditions as well as in the past – this is not unusual and cannot really be avoided. It is because the very stability and incrementalism of its political system – once a distinctive German asset – now seems to stand in the way of a constructive response to the new and highly uncertain demands of a changed world.

The following is a stylised account of central aspects of the German system in its historical stable state, as it came under pressure in the 1990s. The German post-war political economy was organised by institutions that made for high continuity and smooth incremental change, in industry as well as in politics. Germany as a socioeconomic system used to be distinguished by modest cyclical swings over time and generally compressed distributions around high means. Outliers were rare, both at the low and at the high end. Risks were highly ensured, or could not be taken due to institutional constraints, or taking them was not worth it as rewards

were never excessively high. Entrepreneurialism, political or otherwise, is not highly rewarded. There were ample opportunities for actors to prevent other actors from doing something unusual. In stable external conditions this regime supported strategic long-termism and protected actors from being surprised by activist politicians or overly ambitious competitors. The suspicion is that in more turbulent circumstances, what used to be a virtue of stability may have turned into the vice of stagnation.

The *organisation of capital* in the German system is accomplished by corporate hierarchies, inter-firm networks and interactions between firms and public agencies. Large and medium sized firms in Germany are predominantly privately held or in the hands of a few large stockholders exercising tight supervision over managerial agents. Chief executive officers are ‘first among equals’, who must negotiate fundamental decisions about company policy with the executive boards and the supervisory boards of their firms. Corporate leadership cadres have risen through the ranks of the firm and have typically gained their experience in engineering and production divisions. In its investment and growth strategies, the German firm relies mostly on internal resources or bank loans, leaving only a modest role for bond and stock equity markets. The latter are dominated not only by large stockholders, but also by universal banks which own significant shares of company stock and exercise proxy voting rights on behalf of small stockowners. This ownership structure has given rise to a web of interlocking company directorates enabling banks – often with large asset shares in several firms of the same industry – to play a crucial role in companies’ choice of strategy or in their reorganisation.

Within each industry, German business is characterised by a balance of competition and co-operation. Firms compete in product markets but co-operate in the acquisition of inputs and in product and process innovation, particularly firms belonging to the crucial tier of medium sized, privately held engineering companies that account for a substantial share of German exports. Sectoral business associations, nationally tied together under the umbrella of the BDI (German Federation of Industry), provide for the sharing of valuable information among firms, facilitate co-operation and complementarity, and promote joint innovation and international trade strategies.

The *organisation of labour* is also multi-layered, ascending from the individual labour contract via participation in shopfloor decision-making and corporate governance to the levels of regional industrial sectors and national economic co-ordination. There is an extensive legal codification of labour contracts in Germany, watched by union specialists in labour law.

German labour law favours long-term, full-time employment contracts and severely limits the parties' ability to make fixed-term and part-time contracts, as well as the employer's ability to dismiss individual workers. For mass lay-offs, social plans have to be negotiated with employee representatives. The legal framework for workplace representation, the *Betriebsverfassungsgesetz*, supports elected works councils with rights to information, consultation, and participation in decision-making over working conditions. Works councils contribute to social peace and the smooth introduction of innovations by giving the shopfloor a voice in most aspects of everyday working life; they also militate towards the steady employment of a core workforce. A similar effect is caused by co-determination on company supervisory boards, where the number of labour representatives almost reached parity under legislation passed in 1976. Workforce representatives on major works councils and on the supervisory boards of large firms are almost always union members, which ties unions into decision-making at company level.

Wage bargaining in Germany proceeds within a regional and sectoral framework in which industry-wide labour unions and corresponding employer associations negotiate agreements that apply to all firms belonging to the association. Due to the wage leadership of the metal workers' union, this system approximates national peak-level bargaining because the first agreement in the annual bargaining campaign tends to be adopted by unions and employers in other sectors as well. Co-ordinated wage bargaining delivered industrial peace and relatively moderate, productivity-based real wage increases because the monopoly of labour representation made it all but impossible for radical minorities to disrupt bargaining and push for high nominal wages. At the same time, industry-wide co-ordinated wage settlements put pressure on the weakest firms to innovate or go out of business, allowing the strongest firms to accumulate excess profits for investment in their international competitiveness.

At the firm and sectoral level, an important element of the system of industrial relations are the institutions of vocational training, which bring together unions and employers in local chambers of commerce and trade serving as regulatory agencies. Because of the long-term nature of labour contracts, employers are willing to train entry-level apprentices who learn an occupation in firms while also attending public trade schools. This 'dual system' produces a skilled workforce attuned to the needs of industry and able to contribute to incremental innovation.

The *role of the state* and of public authority within Germany is one of *regulation, facilitation* and *delegation* by public agencies, rather than of

direction. The sector of state-owned or subsidised companies is small and public anti-trust agencies keep a watchful eye on inter-firm competition. However, some regulations, such as the law on retail shop opening hours, limit the extent of competition, for example between small and large firms. Furthermore, there have been major exemptions from the principle of competition in the German economy. One important example is the banking sector, where the majority of business accrues to non-profit municipal and state-owned or co-operative savings institutions and banks. When borrowing funds, these public establishments have a competitive advantage vis-à-vis their private sector rivals because lenders see them as lesser credit risks. Other examples of restraints on competition include the health care sector, trucking and shipping, insurance and, of course, agriculture.

Before it was superseded by the European Central Bank, probably the most important market-conforming regulatory authority in the German system was the Bundesbank. Its sole mission was to protect the value of currency. Due to its autonomy from the elected government, the bank was able to stick to non-accommodating interest rate policies to make excessive wage settlements result in unemployment rather than inflation and to stand in the way of expansionary fiscal policies.

As to state *facilitation*, business development is promoted primarily through an infrastructure of public and semi-public research agencies (such as the *Fraunhofer Gesellschaft*), institutions of higher education (*Fachhochschulen* and universities), regional development agencies, as well as subsidised credit facilities for domestic business investments and international trade. *Delegation* of decision-making to the corporate sector takes place, for example, with respect to the specification and enforcement of industrial standards. Most importantly, according to the principle of autonomous wage bargaining (*Tarifautonomie*), business and labour negotiate wages without direct state intervention. And the German Federal Employment Office (Bundesanstalt für Arbeit), a huge bureaucratic organisation with 90,000 employees and field offices down to the local level, was until recently (see Streeck and Hassel, this volume) governed by a board consisting of representatives of employers, unions, and the different levels of the state.

Crucial for understanding the evolution of the German political economy from the 1950s to the 1980s, and its agonisingly slow revamping since then, is the post-war *party system*. Its centripetal logic replaced a centrifugal logic that in the inter-war period pitted anti-democrats of the Left and the Right against a feeble 'Weimar coalition' of democrats in the

centre. The rupture of 1945 led in each of the former fascist countries – Italy, Japan, and Germany – to the creation of an inclusive non-socialist party trying to organise a cross-class electoral coalition, under the label of either Christian or Liberal Democracy. In Germany as a frontline state in the Cold War, post-war politics also involved a withering away and then the political repression of the radical Left. This created space for an ideologically inclusive labour unionism and the rise of a single hegemonic party of the Left, the SPD.

Another example for the decentralised organisation of the German polity is the *welfare state*. Many social services are delivered by private non-profit organisations aligned with associations or churches. Health care and pension systems involve self-governing bodies with client and provider representation, corresponding to central features of what Esping-Andersen⁴ calls a conservative, Christian-democratic welfare state. It provides universal coverage for most citizens, but fragments the organisation of social insurance by sectors and occupational groups. Moreover, it fashions entitlements primarily in the form of transfers rather than benefits. These transfers are proportional to contributions levied as payroll taxes. The redistributive impact of a conservative welfare state is less than that of a social-democratic welfare state where better-off citizens contribute more through progressive general taxation but then obtain the same services as everybody else.

One main reason why the German state is unable to govern unilaterally is its decentralised organisation that makes for multiple institutional veto gates. Most operative administrative tasks are implemented by bureaucracies governed by the Länder or the localities. The entire federal German bureaucracy has fewer employees than a single US government department with its field offices. Furthermore, within the federal system, the Länder have rival or exclusive jurisdiction over a number of important policy areas, such as education.

Federalism also limits the national government's capacity to enact innovative policies. Because the Länder control the second chamber of the German legislature, the Bundesrat, and because most legislation is in areas where the Länder have rival jurisdiction, federal governments must seek the majority of state votes in the second chamber to be able to legislate. In periods of 'divided government', with a different partisan majority in Bundestag *and* Bundesrat, the passage of legislation is particularly cumbersome. Even with unified government, however, ambitious state governors belonging to a party represented in the national cabinet may act on interests different from those of their national leadership.

A final institution that deserves mentioning in this context is the German Federal Constitutional Court (Bundesverfassungsgericht). It exercises far-reaching powers to review the compliance of legislation with the constitution, even ahead of any case heard by a lower court ('abstract' review). Members of the federal parliament and state governors may submit new legislation to the Constitutional Court for review, and the court has handed down decisions that were at variance with those of veto players in other relevant political decision-making arenas.

Historical literature has traced the origins of the institutions of the German political economy and we have nothing new to add here. We would like to insist, however, on the heterogeneity of what in retrospect may appear as an institutional 'system'. Some central German institutions are relics of a pre-industrial past whereas others appeared by historical accident, especially by imposition of the US Allied High Command after World War II. The latter, for example, made it possible for a school of liberal economic institutionalists (*Ordoliberalen*), inspired by F.A. von Hayek and politically represented by Ludwig Erhard, to become influential in the economic policy of the new Federal Republic.

Among the older institutions of the German political economy we find elements of corporate organisation (private firm ownership, large stockholders, universal banks, debt rather than equity financing) and industrial relations (industrial unionism and works councils) as well as the dual vocational training system. They go back to the time before industrialisation (vocational education growing out of the guild system); date from Germany's comparatively late industrialisation in the era of heavy industry and the beginnings of science-based industries (universal and investment banking, corporate governance, industrial self-regulation, public research institutes); came about under the post-1871 empire and Bismarckian authoritarianism (the basic institutions of the German insurance system); in the early twentieth century in the decades before World War I (industrial unionism, business associations and cartels); or just after World War I (works councils and, later, unemployment insurance).

Among recent post-World War II additions to the German system are the de-cartelisation of industry and the introduction of a strict competition regime, promoted by the Western allies in the belief that Germany's organised capitalism made National Socialism possible. Also, allied military governments imposed a 'balanced' federalism, dismembering what was left of Prussia and allocating broad powers to the Länder. They also insisted on an independent central bank and a strong constitutional court,

provisions that were duly incorporated into the constitution of the Federal Republic. Co-determination at company level also had its origin in part in the British effort to politically neutralise the German coal and steel industry, after the American government had vetoed its nationalisation.

Finally, there are critical elements of the German system that have both ancient and modern roots. A case in point is Germany's party system, with its long-standing weakness of democratic liberalism. This originated when German unification in 1871 and Bismarck's coalition policies split the liberal movement in an anti-democratic national-liberal and a much smaller democratic left-liberal wing, the latter being destined to remain a marginal player between the vast blocs in the democratic camp of political Catholicism and Social Democracy. The relative strength of the German social democracy is old as well, of course, while the main innovation after 1945 was, as mentioned above, the Christian-Democratic Party with its cross-class appeal.

After 1949, Christian-Democratic politicians pursued a cross-class strategy primarily through a reorganisation and extension of the welfare state, particularly to the elderly and to small business, but also through improved benefits for core elements of the working class. The Christian-Democratic Party thus became the hegemonic party of the 1950s. Its success eventually compelled the SPD to give up its Marxist ideology to become a serious contender for political power, renouncing its objective to change property relations in favour of extending the democratic class compromise through the welfare state. Other major parties in post-war Germany thus contributed actively to the creation of the German welfare state, with the Social Democrats extending the menu of benefits beyond what Christian Democrats had initially envisaged. Both parties neutralised the small market-liberal opposition to welfare state expansion by co-opting it into the government or by marginalising it through a 'Grand Coalition' between 1966 and 1969.

THE GERMAN PERFORMANCE CRISIS OF THE 1990s

German success became notable in the 1970s and 1980s, when post-war reconstruction, the benefits of an under-valued currency and technological catching-up could no longer explain the country's superior economic performance and political stability. Particularly under the trying circumstances of the oil crises of the 1970s, the German political economy delivered lower inflation, lower unemployment and slightly better economic growth rates than were experienced by most other wealthy Western

democracies. One explanation was that during this period exactly those industrial sectors expanded in global trade in which the German configuration of institutions had comparative advantages. These sectors included the chemical, electro-mechanical and machinery industries, in particular the production of durable consumer and investment goods requiring sophisticated engineering, including all sorts of transportation equipment (especially automobiles), power plants, chemical processing facilities, measurement and fine-mechanical equipment and machine tools.

In the sectors of German strength, precision engineering and quality production relying on highly skilled workers paid off in superior products amenable to improvement through incremental processes of organisational learning and technical innovation. Incremental learning is supported in Germany by an institutional fabric that relies on long-term labour contracts, peaceful labour relations and large or medium sized established firms embedded in co-operative networks with other firms in the same or complementary sectors. Moreover, internal recruitment of engineering-trained management and close relations to house banks made hostile takeovers and corporate break-ups almost impossible. Because German institutional arrangements lowered transaction costs in the interface between capital, labour and the state, German companies could produce goods at competitive prices controlling for quality, despite very high real wages and an appreciating currency.

However, if we place German economic performance in context, it appears the favourable conditions that made Germany excel in the 1970s and into the 1980s vanished in the subsequent decade. In order to compare, we look at the performance of four Anglo-Saxon countries with market-liberal institutions, such as stock market-based financial systems with corporate governance centralised around a single chief executive officer and a weak board, the absence of 'stakeholder' co-governance of corporations through worker participation, fragmented labour unions with limited capacity and willingness to engage in corporatist compacts, and the absence of firm-based vocational training resulting in a high share of low-skilled blue-collar workers and in reliance on general educational institutions for human capital acquisition. Next, we compare three countries with social-democratic or conservative-social democratic institutions and with co-operative corporate governance and industrial relations regimes. Two of them, Denmark and the Netherlands, are today widely discussed as new 'models' of superior economic and political performance.

Further, we include France and Italy, which are countries of almost the same size as Germany and endowed with mixed regimes of corporate

governance, industrial relations, and economic state intervention. Like Germany, however, they have generous transfer-oriented conservative welfare states, promoted by conservative parties that governed for most of the post-war growth period with a cross-class, non-market-liberal appeal. Finally, we look at Japan. While Germany and Japan differ in their institutions of corporate governance, finance, industrial relations, and state–economy linkage, what unites them is the weakness of political liberalism in the electoral and legislative arena, workplace-based human capital formation, a bank-based financial system, and co-operative relations among businesses.

Table 1 shows GDP growth rates from 1990 to 2000 and growth per capita. The Anglo-Saxon market-liberal systems come out ahead of the Northern European social-democratic welfare states which, in turn, lead

TABLE 1
GROSS DOMESTIC PRODUCT AND PER CAPITA GROWTH 1990–2003

	1990–2000 Averages			2001 GDP growth, 2002 estimates and 2003 projections			Per capita growth	
	GDP growth/a	Popula- tion growth/a	Per capita GDP growth/a	GDP growth 2001	GDP growth 2002 (est.)	GDP growth 2003 (proj.)	Per capita GDP growth 2001–3/a	1990– 2010 GDP (1990= 100)
Australia	4.1	1.2	2.9	2.8	3.5	3.2	1.9	161
Canada	2.9	1.0	1.9	1.5	3.5	3.1	1.7	43
UK	2.5	0.4	2.1	2.0	1.5	2.3	1.5	144
US	3.4	1.2	2.2	0.3	2.3	2.5	0.5	131
Denmark	2.4	0.4	2.0	1.0	1.5	1.7	1.0	135
Netherlands	2.9	0.6	2.3	1.3	0.1	0.9	0.2	128
Sweden	1.8	0.4	1.4	1.2	1.7	2.0	1.2	129
France	1.7	0.4	1.3	1.8	1.0	1.5	1.0	126
Germany	1.5	0.3	1.2	0.6	0.4	0.6	0.2	115
Italy	1.5	0.2	1.3	1.8	0.3	1.2	1.1	127
Japan	1.3	0.3	1.0	–0.3	–0.7	0.2	–0.4	106

Sources: GDP growth/a 1990–2000: World Bank, *World Development Report 2002* (Washington, DC: The World Bank, 2002), table 3, pp.236–7; Population growth/a 1990–2000: World Bank, *World Development Report 2002*, table 1, pp.232–3; GDP growth 2001, estimate 2002: OECD Economic Outlook, December 2002, statistical appendix; GDP growth 2003, projection: latest available forecasting average of economic research institutes, reported in *The Economist*, 15 Feb. 2003, p.97; Per capita GDP growth 2001–3: GDP growth figures, corrected by average population growth figures 1990–2000; Per capita growth 1990–2010: per capita GDP growth 1990–2000, plus projection of per capita growth 2001–3 for the entire period from 2001 to 2010.

France, Italy and Germany, the three large continental countries with cooperative or mixed market institutions. Japan trails everyone. But when comparing columns 1 and 3, note that the differences between countries and groups of countries shrink once population growth is taken into account. Germany grows less than the other countries except Japan, by up to one percentage point per year, although it is only marginally behind France, Italy and Sweden.

Germany's laggard position becomes more pronounced in the following decade. On a per capita base, economic growth in 2001–3 is barely perceptible (column 7).⁵ It is less than half of the – low – per capita growth rate of other European countries (except the Netherlands), and especially far behind that of the market-liberal economies (with the exception of the United States). For an – inevitably shaky – projection, one may set each country's 1990 per capita income equal to 100 and use 1990–2000 historical growth rates and 2001–10 growth rates based on 2001–3 estimates. US per capita income would then move ahead of Germany's by 16 per cent in the short span of 20 years, and by a whopping 25 per cent ahead of Japan's (column 8). The best performers, by far, would be the other countries of the Anglo-Saxon group and Denmark. In other words, Germany has for some time belonged to a group of slow-moving countries, but must worry about trailing even that group and becoming more like Japan.

Next we examine German growth in relation to overall and sectoral employment for the most recent decade on which data are available, 1989–98 (Table 2). Economies can grow by adding more labour and by improving its use. As the table shows, Japan has been adding labour at an already very high level of employment for very low growth. It also has the largest industrial sector of all countries compared. In three de-industrialised or rapidly de-industrialising liberal market economies – Australia, Canada and the United Kingdom – high per capita growth combines with substantial labour savings and high employment, particularly in the private business sector and in consumption-related services. The United States, Denmark and, in particular, the Netherlands represent an intermediate combination of high growth with, mostly, rising labour input. While in the US higher labour input added to an already very high employment level, the employment increase in the Netherlands was the result of a successful effort to move away from 'welfare without work'.

Finally, Germany belongs to a category with low growth and declining employment, at low overall employment (except for Sweden, where employment is still high). For a welfare state this is the worst possible combination. The German disease is shared by other conservative welfare

TABLE 2
GROWTH AND EMPLOYMENT

	GDP growth per capita 1990–2000	Percentage of the 15–64-year-old population in employment					
		All employment		Industrial sector		Consumer-related services	
		Change 1989–98	1998	Change 1989–97	1997	Change 1989–97	1997
(1)	(2)	(3)	(4)	(5)	(6)	(7)	
<i>Group I: high growth, strong labour savings</i>							
Australia	2.9	–0.7	68.5	–3.0	15.1	1.8	35.4
Canada	1.9	–2.1	69.9	–2.4	15.7	–0.2	36.3
United Kingdom	2.1	–1.5	70.3	–4.5	18.6	1.7	35.2
<i>Group II: high growth, weak labour savings</i>							
Denmark	2.0	–0.3	75.8	–0.7	20.0	1.8	38.4
Netherlands	2.3	8.3	61.8	–0.7	15.0	4.1	34.9
United States	2.2	2.1	73.9	–1.5	17.6	3.1	41.7
<i>Group III: low growth, strong labour savings</i>							
France	1.3	–0.9	59.4	–2.6	14.7	2.2	29.5
Germany	1.2	–3.4	60.5	–2.0	23.1	1.3	28.1
Italy	1.3	–2.2	50.8	–1.2	16.1	–1.5	24.0
Sweden	1.4	–11.7	69.6	–6.2	17.9	–5.1	37.1
<i>Group IV: low growth, weak labour savings</i>							
Japan	1.0	2.9	74.8	0.4	24.9	3.3	34.7

Sources: Per capita GDP growth: see Table 1. Labour market participation data for all employment, business sector, industrial sector and consumer-related service sector: see F.W. Scharpf and V.A. Schmidt (eds.), *Welfare and Work in the Open Economy. From Vulnerability to Competitiveness* (Oxford: Oxford University Press 2000), Vol.1, data appendix, Tables A-5, A-7, A-9, and A-10.

states with co-operative or mixed market economies which, like Germany, have small consumer-oriented service sectors (column 9). Germany stands out for its very large industrial sector. In the decade from 1989 to 1998, this sector shrank considerably less than one would have predicted based on changes in the other countries except Japan.⁶ Together with the high German export surplus, this testifies to the unbroken strength of German manufacturing. At the same time, like the other conservative welfare states, Germany appears to be stuck in a pattern where declining labour inputs in industry cannot be compensated by growing employment elsewhere. This is different in Sweden, which started from an extremely large consumer service sector in 1989 combined with an extremely high labour market participation rate, and shed employment in all sectors to restore competitiveness.

The employment problems of Germany and other continental European economies also relate to labour costs and competitiveness (Table 3). The first two columns show the total change of real unit labour costs in manufacturing for the last two decades of the twentieth century. They reveal that Germany suffered from rising labour costs in the 1980s, when labour costs elsewhere declined, followed by a significant reduction in the 1990s. Note that high growth performers in the 1990s had the greatest reduction in unit labour costs in the 1980s and 1990s taken together (column 3), such as the Netherlands, Canada, the United States and, based on a recent effort, also Sweden. Germany, it would seem, tried to restore its competitiveness in the 1990s mainly by shedding labour in its industrial core sector, where opportunities for economic and employment growth are limited.

Germany continues to enjoy overwhelming advantage in the export of conventional manufactured goods. Table 4 shows the percentage of world trade in different functional categories for 11 leading capitalist democracies in 2000. To make the data more easily comparable, we calculate the percentage of world trade per million inhabitants, multiplied by 100 to make figures more readable (column 1, in brackets). Germany performs extremely well overall. Its world market share is highest, however, in manufactured goods (column 3) while performance in the fastest growing segment of manufacturing, high technology products, is weaker (column 4). In the rapidly growing area of commercial services, German performance is weakest (column 5). In comparison, Britain, the United States and France, among the larger countries, generally have higher world market shares in the cutting-edge sectors of high technology and business services than in manufacturing. Japan is stronger than Germany in high technology markets but weak in business services.

Table 5 focuses only on the largest five economies. It presents the expected world market share in all goods and services taking into account population size⁷ (row 1.1) and the difference to the actual share for each country (row 1.2) to provide a rough measure of relative competitiveness. Germany performs better than any other G-5 country in overall exports as well as manufacturing exports (row 1.3), but ranks only fourth in high technology and in commercial and business services (rows 1.4 and 1.5).

Moreover, the second part of Table 5 shows that since 1990 Germany has experienced the weakest overall growth in all exports as well as in its strong manufacturing sector (row 2.2). We take this to indicate that without diversification Germany's manufacturing base may melt away in coming decades. There is not one area where Germany's export growth equals or

TABLE 3
CHANGE IN LABOUR PRODUCTIVITY 1980–98

	Percentage change in real unit labour cost		
	1980–89	1990–98	1980–98
Australia	-6.9	-0.5	-7.4
Canada	-7.3	-7.4	-14.7
United Kingdom	-4.7	-3.2	-7.9
United States	-10.0	-3.2	-13.2
Denmark	-1.2	-4.7	-5.9
Netherlands	-14.4	-7.0	-21.4
Sweden	-4.8	-9.0	-13.8
France	-8.6	-0.2	-8.8
Germany	+2.5	-6.8	-4.3
Italy	-2.4	-5.7	-8.1
Japan	-4.9	+2.4	-2.5

Sources: Real unit labour costs: F. Scharpf and V.A. Schmidt (eds.), *Welfare and Work in the Open Economy*, Vol.1 (Oxford: Oxford University Press 2000), Vol.1, data appendix, Table A-17.

TABLE 4
WORLD EXPORT MARKETS:
COUNTRY SHARES OF WORLD GOODS AND SERVICE EXPORTS

	All goods and service exports (% of world exports per million inhabitants* 100 in brackets) (1)	Merchandise exports (% of world exports) (2)	Manufactured goods export (% of world exports) (3)	High technology exports (% of world exports) (4)	Commercial service exports (% of world exports) (5)
World	\$7,950 bn	\$6,350 bn	\$4.953 bn (78% merchan- dise exports)	\$990.6 bn (20% man'd goods exports)	\$1,455 bn (89% all service exports)
Australia	1.0 (5.5)	1.00	0.4	0.3	1.2
Canada	3.95 (12.7)	4.4	3.6	3.4	2.5
UK	5.1 (8.4)	4.4	4.6	7.4	7.9
US	13.5 (4.8)	12.3	13.1	22.3	18.7
Denmark	0.9 (18.9)	0.8	0.6	0.7	1.7
Netherlands	3.6 (22.5)	3.3	3.0	5.3	3.5
Sweden	1.4 (15.0)	1.4	1.5	1.6	1.4
France	5.1 (8.7)	4.7	4.9	5.9	5.6
Germany	8.0 (9.8)	8.7	9.5	8.5	5.5
Italy	3.7 (6.4)	3.7	4.2	1.9	3.8
Japan	6.9 (5.4)	7.6	9.1	12.7	4.6

Sources: Calculated from World Bank, *World Development Report 2002*, pp.238–9; merchandise exports 2000, *World Development Report 2003*, pp.240–41; high technology exports 2000 as percentage of manufacturing exports, manufacturing 2000 as percentage of merchandise exports and World Bank Development Indicators (online), all goods and services.

TABLE 5
RELATIVE TRADE COMPETITIVENESS: THE G-5 COUNTRIES

	UK	US	France	Japan	Germany
<i>1. Relative export shares</i> (per cent world trade, per million inhabitants*100)					
1.1. Goods and services (expected share, predicted by country size)	9.0	3.2	9.1	6.3	7.9
1.2. Goods and services (difference of actual minus expected share)	-0.6	+1.5	-0.4	-0.8	+1.9
1.3. Manufactured goods (difference of actual minus expected share)	-1.3	+1.4	-0.4	+0.8	+3.5
1.4. High technology (difference of expected/actual share)	+3.3	+4.6	+1.3	+3.7	+2.4
1.5. Commercial and business services (difference of expected/actual share)	+4.1	+3.3	+0.8	-2.6	-1.3
<i>2. Export growth</i> (annual per cent rate, 1990-2000)					
2.1. Goods and services (world annual growth rate: 6.5)	3.9	7.1	3.3	5.2	2.8
2.2. Manufactured goods (world annual growth rate: 5.2)	4.8	8.3	4.7	5.0	2.3
2.3. High technology goods (world annual growth rate: 8.5)	7.6	8.7	9.0	6.8	7.2
2.4. Commercial and business services (world annual growth rate: 6.8)	7.9	7.5	0.3	4.6	5.2
<i>3. Export-import ratios 2000</i> (exports as per cent of imports)					
3.1. Goods and services	91.6	72.6	102.0	110.3	100.7
3.2. Manufactured goods	82.9	66.8	102.3	208.7	138.1
3.3. Commercial and business services	124.0	130.0	132.0	58.9	60.9
<i>4. Change in export-import ratios 1990-2000</i> (difference of 2000 minus 1990 ratios)					
4.1. Goods and services	+3.0	-12.6	+2.3	+7.2	-10.3
4.2. Manufactured goods	-4.0	-8.4	+5.8	-56.7	-8.4
4.3. Commercial and business services	+4.0	-5.0	+6.3	+13.0	-4.5

Sources: All calculations from sources given in Tables 3 and 4. The regression of population on goods and services export share/million of inhabitants is 24.31-8.60 log population/million ($r = -0.75$).

surpasses world averages. German weakness is least pronounced in the high technology area, where Germany ranks fourth, but not far behind the leaders. The United States tops world average growth rates in all four categories, while Britain and France lead in one of each of the two most dynamically growing areas. Only Japan, like Germany, remains below the world average in all respects.

German export-import ratios in the aggregate of goods and services as well as in manufactured goods, while still high or at least balanced (rows 3.1 and 3.2), have lately been declining (rows 4.1 and 4.2). Also, the country's laggard position in commercial and business services has worsened (rows 3.3 and 4.3), confirming the picture of eroding German competitiveness.

Japan's extraordinary export–import ratio in manufactured goods declined in the 1990s (row 4.2), but the country begins to make up for this by improving its balance of trade in business services, with growth in the 1990s (row 4.3) albeit still at a very low level (rows 3.3). The competitiveness of Anglo-American liberal market economies continues to decline for general manufactured goods, which are increasingly imported from Asia, but holds firm in commercial and business services (rows 3.3 and 4.3). France shows the most balanced development, although its growth in commercial services is minuscule (row 2.4), notwithstanding a high export surplus in this area (row 3.3). It is fair to conclude that, from a dynamic perspective, Germany exhibits the weakest competitiveness profile among the world's five largest economies over the course of the 1990s.

What are the distributive correlates of German economic development? We can examine this in terms of wages and household incomes, with the two not necessarily yielding the same cross-national pattern given varying rates of labour market participation over time and across countries. Column 1 of Table 6 presents the 90–10 ratios of wages for men in the mid-1990s,

TABLE 6
PATTERNS OF WAGE AND INCOME INEQUALITY

	90: 10 ratios of wage earners' income (men only) mid-1990s	90: 10 ratios of wage earners' income (% change) 1980– mid-1990s	Household GINI coefficient, mid-90s	Household GINI coefficient (% change) 1980– mid-1990s	Ratio of highest decile income or consumption to lowest decile mid-1990s
	(1)	(2)	(3)	(4)	(5)
Australia	3.0	+10.1	31.7	+10.5	12.7
Canada	3.8	+8.4	28.6	0	8.5
UK	3.4	+28.7	34.6	+28.1	10.5
US	4.8	+32.7	37.5	+21.4	16.9
Denmark	no data	no data	24.0	–6.6	5.7
Netherlands	2.7	+16.4	31.0	+9.9	9.0
Sweden	2.4	+11.8	22.2	+12.1	5.4
France	3.3	–2.7	32.4	+9.1	9.0
Germany	2.9	–4.7	30.0	+22.4	7.2
Italy	2.4	+16.7	34.6	+12.0	6.2
Japan	2.8	+7.3	no data	no data	4.5

Sources: Wage 90/10 ratios and their change, GINI coefficients: J. Pontusson, 'Social Europe versus Liberal America. Inequality, Employment and Social Welfare in the Global Economy' (manuscript, Department of Political Science, Cornell University, December 2000) Tables 2.3 and 2.8; GINI 90/10 ratios: World Bank, *World Development Report 2002*, Table 2, pp.334–5.

that is, the multiple of income received by a wage earner in the 90th percentile compared to a wage earner in the 10th percentile. Column 2 presents the percentage change in the multiple since 1980.

The figures show that Germany is one of the more egalitarian countries. From 1980 to the mid-1990s, inequality actually declined whereas in most other countries it rose substantially. The increase was particularly pronounced among the already inegalitarian market-liberal economies, led by the United States. But there is also a distinct increase in Sweden, Italy and the Netherlands, though from a baseline of high equality. Together with figures presented earlier, this suggests that for Germany the tenacious defence of wage compression in the industrial sector has made it impossible to create many new jobs in this sector or elsewhere, due to national co-ordination of wage bargaining across regions and sectors.

Greater wage compression in Germany, however, does not directly translate into greater household income equality, as captured by the GINI coefficient (columns 3 to 5). Because of the shrinking manufacturing sector and shrinking employment as a percentage of the population, fewer people benefit from wage compression. By the mid-1990s, Germany had a more equal distribution of household income than Anglo-Saxon market-liberal economies, except Canada, France or Italy (column. 3). But over the preceding 15 years income inequality had risen almost about as fast as in Britain and the United States (column 4). Still, this left the position of high-income compared to low-income households considerably lower than in all the market-liberal economies as well as in France and the Netherlands (column 6).

The overall picture, then, is one of a German political economy that produces only slow innovation and adjustment. Growth trailed most other major economies in the 1990s and the gap has recently widened. Industrial employment has fallen slower than one might have expected, given its comparatively high level in the late 1980s; similarly, consumer-oriented service employment has grown more slowly than the relatively small size of the sector would have led one to believe. Slow structural change combines with a gradual decline of unit labour costs in manufacturing and, reflecting Germany's traditionally strong competitiveness in established industrial sectors, only a minor decline in manufacturing employment. The German economy encounters difficulties entering new and technologically advanced industries and the growing sector of business services. Slow political and economic change coincides with a pattern of continued wage compression in industry accompanied, however, by rising inequality of household incomes.

THE ETIOLOGY OF DECLINE: WHY GERMANY HAS RUN INTO TROUBLE

The decline of the German political economy has multiple causes that often reinforce each other. While the symptoms of decline can generally be related to external shocks – such as increased exposure to international competition, technology-induced changes in terms of trade and relative competitiveness, or changes in demography and consumer demand – it is the ways in which political and economic actors have responded to these challenges that account for Germany's relative economic weakness in the new century.

Foremost among the challenges facing the German political economy are technology- and demand-induced gradual changes in the growth potential of economic sectors since the 1970s. Conventional manufacturing, where Germany's institutions of corporate governance, long-term employment and co-operative, organised industrial relations provide a comparative advantage, are no longer growing fast. In high technology sectors and especially in business and commercial services Germany lags behind other leading post-industrial economies, particularly those equipped with decentralised, fluid industrial relations, more precarious employment, and equity-driven capital markets.⁸ While Germany has made the best of its still strong manufacturing sectors, such as machine tools, heavy engineering, automobiles and aerospace, these account only for shrinking segments of the post-industrial economy.⁹

Throughout the period under observation, Germany has maintained high levels of gross capital formation exceeded only by the Japanese economy (Table 7). This was good enough to stay abreast of developments in the traditional areas of Germany's strength. But the German political economy did not mobilise the additional capital needed to innovate in new areas because of the institutional bottlenecks it has encountered. Differences in gross fixed capital formation from 1990 to 2001 (Table 7, columns 2–5) do not explain different growth rates. Japan, which had the highest levels of investment in the 1990s, also had very low economic growth. What matters for economic growth is whether and to what extent *additional* investment is allocated to new and at the margin to highly productive areas of economic activity, even though accelerating rates of new investment are slow to translate into higher overall investment. Indeed *growth rates* of capital investment (Table 7, column 1) and per capita economic growth in the 1990s (Table 1, column 3) are robustly correlated ($r = +.75$).

There is also only a weak direct link between economic performance, for example per capita GDP growth, and the inflow of foreign direct investment

TABLE 7
GROSS FIXED CAPITAL FORMATION 1990–2001

	Annual change rates of gross fixed capital formation 1990–99 (%)	Levels of gross fixed capital formation (% of GDP)				Net balance of FDI, average 1990–99, % total capital formation*
		1990	1999	2000	2001	
Australia	6.1	21	22	25	24	8.0 (–5.6)
Canada	2.6	21	20	20	20	9.2 (–2.3)
UK	1.8	19	16	18	18	15.9 (+7.7)
US	7.0	17	19	20	21	6.0 (+5.2)
Denmark	4.8	20	21	20	22	11.4 (–8.9)
Netherlands	1.5	22	20	22	22	19.0 (+4.4)
Sweden	–2.2	21	14	17	18	32.0 (+14.6)
France	–1.6	22	17	19	21	8.5 (+0.2)
Germany	0.5	23	21	22	23	2.6 (–4.2)
Italy	–1.0	21	18	20	20	1.8 (–6.7)
Japan	1.1	32	29	26	26	0.2 (–4.5)

Notes: * in brackets: difference between actual and expected net FDI after stripping out log country population size.

Sources: Columns 1–3 from World Bank, *World Development Report 2000–1*, Table 11, pp.294–5 and Table 13, pp.298–9; column 4 from World Bank, *World Development Report 2002*, Table 3, pp.236–7, column 5 from World Bank, *World Development Report 2003*, Table 3, pp.238–9, column 6 from World Development Indicators, online (complete data for more than 6 countries only for 1990–99). The regression of log population on net foreign direct investment as percentage of total capital formation that yields the size-corrected expected values for each country is: $FDI_{net} = 27.84 - 11.02 \log \text{population}$ ($r = -0.62$).

(Table 7, column 6), whether country size is ignored or stripped out of the data (figures in brackets). What can be said, however, is that large and slow-growing economies with reasonably open capital markets in the 1980s and 1990s display low rates of net foreign direct investment (Germany, Italy, Japan and, to a lesser extent, France). With the partial exception of France, these are also the countries in which institutional conditions are unfavourable to high competitiveness in the most dynamic areas of the post-industrial economy.

Germany's anaemic growth in capital formation and its low capacity to attract capital from abroad in the 1990s, together with its weak per capita economic growth, demonstrate the indispensable role of new investments for economic growth. What prevented an acceleration of capital investment? German institutional arrangements offer at least five reasons why investment extending Germany's comparative economic advantage

into new sectors has not sufficiently taken place. We will not venture into calibrating the relative importance of each factor, but confine ourselves to a list of the causal mechanisms we believe to be at work.

1. The organisation of German capital and labour markets has offered too little flexibility for those new investments in manufacturing or business services that do not thrive when venture capital is hard to get, banks prefer to deal with established firms, regulatory obstacles prevent easy access to equity capital markets, and industrial relations make it difficult to hire people on an experimental, temporary basis. In addition, regulatory requirements have often sufficiently intimidated prospective investors to make them locate innovative activities outside Germany.
2. German institutions negatively affect not only the employment, but also the formation of human capital. Mediated by two hegemonic political parties that depend on the organisational and voting power of employees and former pensioners, the German welfare state has a strong bias towards protecting existing occupational structures and entitlements (Leibfried and Obinger, this volume). In the 1980s and 1990s, this shifted resources away from upgrading the educational system, as reflected in the deterioration of the universities in the last quarter of the twentieth century due to steadily falling real expenditure per student. By 2000, Germany had too few university graduates, many of them with inferior or outdated skills (Mayer and Hillmert, this volume). While this has recently been recognised, new resources for human capital investment would in effect have to be taken from social programmes serving powerful social-protectionist interests, in a competitive political environment in which parties going against such interests have invariably been punished in federal elections (Kitschelt, this volume).
3. The low level of additional investment necessary for structural economic change is further related to defensive labour supply management. Germany, in Esping-Andersen's terms,¹⁰ is a conservative Christian-democratic welfare state that favours full-time wage earners and has coped with unemployment by taking growing numbers of people willing and able to work out of the labour market (Streeck and Hassel, this volume). As the number of contributors to the social insurance system declined while expenditure increased, payroll taxes went up even though individual benefits have been cut back since the 1970s. Relief was also provided by a temporary decline in the dependent population, due to the retirement of the small age cohorts affected by the war and to labour market entry of the post-World War II baby boom generation.

Still, the surpluses generated in the thriving manufacturing sector in the 1980s were in large part siphoned off to pay for early retirement and unemployment benefit, subsidising the labour market regime of the industrial period at the expense of new investment.

4. Incremental corrections may have reversed the decline, and in the late 1980s some steps in this direction were under way. They were undone, however, by the historical accident of German unification. Adding to and reinforcing the unfavourable dispositions of the German system, unification made it more difficult for politicians and the government to face up to the needs for political-economic reform (Wiesenthal, this volume). Foreign policy imperatives required the immediate absorption of the GDR into a unified Federal Republic. The speed of the incorporation made it all but impossible to contemplate changes in the West German institutional framework. The faltering East German economy – suffering from over-industrialisation, under-investment in infrastructure, and a no more than rudimentary service sector – instantly created millions of new beneficiaries of the German welfare state entitled to unemployment compensation, early and regular retirement pensions, social assistance, and training and retraining measures that often led nowhere. As a result, investment in structural change was even more crowded out by social consumption than before, and shifting resources from consumption to investment in business and human capital became politically even more difficult. Unification caused costly delays in the necessary restructuring of the German pension, health care and education systems, which in turn made it only harder, if not entirely hopeless, to address the same issues more than a decade later, with many more stakeholders in the status quo. If the surplus that can be extracted from a society is limited, dedication of a large share of it to social consumption and to the subsidisation of traditional structures cements such structures as it deprives the society of the means to invest in innovation.
5. European integration and financial globalisation have put additional strains on economic sectors that in the past could live with the German welfare state because they were protected from international competition. Since the Maastricht Treaty of 1992, many regulatory and fiscal supports have fallen by the wayside or been challenged, in sectors such as telecommunications, the railways, aviation and trucking, as well as banking and insurance. Other pressures on domestic firms from European integration include new rules on competition, affecting for example municipal savings banks, co-operative banks and state banks,

and public procurement. Typically liberalisation resulted in significant employment losses causing, in turn, further increases in social welfare spending.

So far, we have focused on the interrelated complex of market and technological pressures for change that have built up since the 1970s and clashed with the institutional predispositions of the German political-economic model, and on the reinforcement of such predispositions by unification. In a more forward-looking analysis, two further problems must be added that have gained virulence over the last several years, the effect of European integration on the political capacities of the German state and the beginning demographic revolution.

During the negotiations surrounding the Maastricht Treaty, Germany successfully insisted on the Europe-wide adoption of at least one crucial element of the German political-economic model, a powerful independent central bank as a guardian of monetary stability. In Germany, under conditions of co-ordinated wage bargaining, a case can be made that the anticipation of restrictive monetary policies with growth-dampening effects made unions put up with moderate nominal wage increases,¹¹ or at least made them support measures to increase productivity, including reduction of workforces through early retirement, to catch up with wage increases. Extension of the German monetary regime to the Euro currency area through the European Central Bank, however, required a number of countries to put up with a strong independent central bank that lacked the strategic capacities necessary for co-ordinated wage setting. As a consequence of different wage bargaining regimes in various European countries, and more generally of divergent business cycles, the restrictive monetary policies of the European Central Bank may hurt member states whose economic and institutional conditions require or permit more accommodating policies. This has recently been the case with Germany. High real interest rates under conditions of wage moderation have stifled economic growth at a time when domestic conditions, including the burden of unification, would have called for monetary expansion.¹² In this respect as in others, as Jeffery and Paterson argue (this volume), institutions German policy-makers bargained for at the European level now have begun to haunt them by inflicting additional burdens of adjustment on their domestic economy.

The greatest challenge in the long run, however, may be the impending demographic revolution. It interacts in a variety of ways with current German political-economic institutions. Germany is about to face a

'greying' of its population without historical parallel (Minkenberg, this volume). The ratio between the recipients of social transfers and the contributors to social insurance funds will grow progressively worse until the middle of the twenty-first century, unless more immigrants settle in Germany and assimilate into its economic, political and cultural environment; domestic fertility rises closer to replacement levels; more women join the labour force, as in market-liberal and social-democratic, but not in conservative welfare states; and the terms of retirement (age to qualify for full pension; pension levels; the relationship between pay-as-you-go and funded pension entitlements) become less generous.

Increasing immigration raises a large number of questions, many of which are addressed in Minkenberg's contribution. The older generation of current welfare state beneficiaries has the least tolerance for cultural pluralism and will not benefit from immigration in future decades. Moreover, better acculturation of more immigrants, to enable them to make productive contributions, would require significant investment. Not least, accelerated immigration would have to begin at a time when domestic labour markets have not yet been emptied by the demographic shift and unemployment is high, generating suspicion that newly arriving immigrants will only take jobs away from Germans.

The three other possible responses to the demographic crisis conflict with the Christian-democratic conservative welfare state and the corresponding industrial relations regime. Increasing employment may require less generous unemployment benefits. It would also involve an expansion of sectors providing personal care services. Given the ageing of the population, there will be high demand for such services, but it will become effective only if ways are found to make them affordable. Above all, this would require lower non-wage labour costs. The greatest reservoir of people to be drawn into the labour market is certainly women, many of whom currently stay at home with or without children. Enabling them to seek employment would require more childcare facilities and all-day schooling. The cost of these would probably have to be covered in part by employees themselves through higher taxes, and in part by reducing existing benefits accruing to clients of the health care and pension systems. Both would run into opposition from the social protectionist currents that defend the German welfare state.

COPING WITH DECLINE: POLITICAL MECHANISMS GENERATING
IMMOBILITY

Under favourable conditions of the sort we have spelled out above, the key characteristics of the German political process – divided authority and jurisdictions, multiple veto points and veto players, disposition towards compromise and political stability among all actors – constituted a virtue that kept system parameters in place and led the system back to equilibrium after minor perturbations. However, when exogenous conditions fundamentally changed, at first imperceptibly, but then at an accelerating pace in the 1990s and after, the incrementalism and stability of German political institutions became fetters of productive adjustment and of creative coping with new situations. It will have to be seen whether the deepening economic crisis of the new century, in interaction with the electoral incentives of politicians, may result in institutional change giving rise to new problem-solving capacities in Germany's political economy.

German institutions and practices that used to provide for stability under conditions of comparative advantage, yet cause immobility in response to changing conditions eroding such advantage, can be divided into five complexes that interact with one another.

Functional interest mobilisation and intermediation. This arena is primarily the organisation of business and labour at firm, sectoral and economy-wide levels. The prevailing coping mechanisms here have been sectoral agreements between employers and wage earners, represented by business associations and trade unions. The bargaining mode promoted equalisation of market conditions for all firms in a sector, and wage compression within and even across skill profiles among workers. As the articles by Streeck and Hassel, Berger and Höpner, and Wiesenthal indicate, a growing number of firms, if not entire sectors, find that these arrangements limit their ability to adjust to changing markets. This applies particularly to medium sized enterprises with less flexibility in the redeployment of human capital and fixed assets. As long as unemployment benefits were generous and early retirement guaranteed workers almost painless exit from the labour market by their mid-50s, unions fought any change in the collective bargaining regime tooth and nail. The East German labour market situation in the 1990s only strengthened their passive resistance. Since unification, the bargaining system has been fraying at the edges, with individual employers exiting and sectoral collective agreements hollowed out by supplementary firm-level agreements between managements and works councils. Recently, unions have included rules in sectoral agreements to enable firms, with the

permission of the parties to the sectoral agreement, to deviate from the latter if their works councils agree, for example to preserve employment or make new investment possible.

Electoral competition and partisan policy-making in the interplay between legislative and executive authority. Germany's party system is based on two major cross-class parties with a record and reputation of support for the country's welfare state, facing very weak market-liberal competitor (Kitschelt, this volume). The result is a pattern of centripetal competition in which any major party pursuing painful economic reforms is punished by an electorate in which a social-protectionist majority prevailed all the way through the 1998 and 2002 federal elections. As a consequence, neither the major governing party nor the opposition party have dared touch the political-economic status quo, and when they have tried or promised to do so, they have lost the election. Recent elections, however, also show a gradual realignment in which social-protectionist voters begin to move out of the Christian-democratic and possibly even the Green partisan constituencies and are replaced by more liberal-minded voters. This might embolden the main opposition party to exhibit a more clearly contoured market-liberal policy profile.¹³ Under conditions of a deepening economic performance crisis, this could win it a West German majority large enough to create a reform-oriented national majority, even if social-protectionist views still prevail in East Germany.

Extra-institutional social movement issue politics. As Rucht shows, political street protest as a way of mobilising dissent continues to be vibrant. But this has not prevented many social movement entrepreneurs, particularly at the municipal level, to enter into bargaining arrangements with the political establishments that draw them and their followers into the political status quo. Especially left-libertarian movements (women, ecologists, local reform and democracy movements) have benefited from an expansion of public sector services and from increasing jurisdiction of political decision-making in areas that earlier would have been under the control of regulatory technocrats or left to market allocation. This tendency towards a 'politicisation of production' through multi-partite bargaining is exactly what may stifle the adjustment of businesses to changing market conditions. In the process, a large proportion of social movement activities has changed its character from challenging the political-economic status quo to defending the accommodations found with established parties and interest groups. Movements that clearly have resisted integration, such as

right-wing anti-foreigner and racist groups, add in their own way to the defence of the status quo by making it politically more difficult to devise an immigration policy consistent with Germany's demographic realities and economic requirements in subsequent decades.

Multi-level territorial division of jurisdictions. It is not only the specific alignment of interests in the functional, electoral-representative and direct democratic political arenas that slows down authoritative decisions in Germany. As Scharpf pointed out more than a quarter of a century ago, German co-operative federalism is a system of interdependent state and national-level decision-making that makes it all but impossible to redistribute resources and co-ordinates decisions around the smallest common denominator of all veto players.¹⁴ The co-operative nature of German policy-making is reinforced by the construction of the second legislative chamber, the Bundesrat, which consists of the state governments rather than of directly elected state representatives. Partisan and regional differences among state governments and between state and national governments can and often do block federal legislation. German co-operative federalism contrasts with 'market preserving' federalism in which subnational units are left to compete with each other within common national parameters that preserve certain collective goods.¹⁵ As Wiesenthal concludes (this volume), a deepening crisis may induce a move from co-operative to market preserving federalism, in which states are free to engage in trial-and-error experimentation to find new ways to remedy political-economic deficiencies.

Judicial review of authoritative decisions by the Constitutional Court, whose members are appointed in a complicated process that requires consensus among the major parties and yields something like proportional representation. The Constitutional Court, however, is not simply an extension of partisan power. It has operated as an independent veto player on a number of occasions and blocked reforms, even those passed with cross-partisan support. Also on economic matters such as taxation and social insurance, the court has been a formidable power to restrain political innovation emanating from the legislative and executive arenas.

In the 1990s and later, all of the five categories of institutional mechanisms were used to block political-economic reforms. Nevertheless, institutions are not exogenously given and may themselves become objects of bargaining and formal or informal revision. For example, a lasting economic crisis may cause voter defections at the margin from what

Kitschelt characterises as the social-protectionist coalition ruling German politics. As politicians perceive promising electoral prospects of more vigorously liberal positions on economic reform, policies and their outcomes are likely to change.¹⁶ As in Scandinavia, the electoral lure of liberalisation may extend even to social-democratic parties and governments, provided their strategists see little risk of their voters defecting to new leftist social-protectionist alternatives.¹⁷ Perhaps a lasting crisis of economic performance may also alter the operation of functional interest intermediation, direct democratic politics, and judicial review in the German system.

FROM STAGNATION TO REFORM?

Social science deals with unique historical events and with decisions contingent on uncertain expectations. Its capacity to make precise predictions is, therefore, woefully limited, especially predictions relevant to the short time horizons of normal politics. Uncertainty rules, not just for the observer but also for the actors themselves. Social science can, however, inform us on the broad parameters of social situations and structures and on the general constraints and opportunities they present to actors trying to achieve their objectives within them.

The German crisis of hyper-stability, or stagnation, due to ingrained over-commitment to old institutions and historical entitlements and to underinvestment in new capabilities, is so deep and has become acute in so many arenas at the same time that it can clearly not be resolved at one stroke, at one time, and in one place. Not only the pension system is in the doldrums today, and not just health care, labour market policy, or the finances of local communities. University reform is needed as much as reform of vocational training, and the German system of industrial relations has reached its limits in the same way as, say, German immigration policy. Finding simultaneous solutions to this multiplicity of interrelated crises must overcharge the capacities of any single actor or institution, however farsighted and powerful.

Emblematic of what may be the ultimate deficiency the past politics of the 'stable state' have conferred on the German system of today would seem to be a law, passed under the Red-Green government in its first period of office, that makes it illegal for the Länder to collect fees from university students. Afraid of appearing *unsozial* to a broad middle class that believes it benefits from free university education – while actually suffering from its declining quality – the CDU/CSU let the legislation pass the Bundesrat.

Cases like this, in which an experimental search for new solutions at the ground level is narrowly circumscribed or altogether outlawed in the name of equality and social protection, abound in the German system. It is here, we believe, that the character of the ‘German disease’ of the early twenty-first century becomes most visible.

How curable is this disease? We suggest that the worsening economic crisis at the end of 2002 may finally have generated public perceptions and electoral incentives that at least in the short run may allow for more than cosmetic economic and institutional reforms. In early 2003, the humiliating defeat of the SPD in the first state elections of the new federal term destroyed any hope for the Red–Green coalition again to cobble together, on a case-by-case basis, majorities in the Bundesrat for individual pieces of legislation. What is worse, the prospect of losing the May 2005 Land election in North Rhine-Westphalia (NRW), the main SPD stronghold since 1966, raised the spectre of a two-thirds CDU/CSU majority in the Bundesrat, which would give the opposition a veto on each and every one of the government’s legislative proposals. Neither the government nor the SPD may ever recover from this. It is conceivable that a political crisis has finally arrived that is as deep as the economic crisis – and deep enough to persuade the SPD to adopt a policy of liberal reform, against its own traditionalist constituencies, so as to reach out to centrist voters afraid that otherwise decline will continue indefinitely.

This, at least, may have been the rationale behind Schröder’s much advertised official statement of policy (*Regierungserklärung*) of 14 March 2003, in which he embraced almost all of the economic and social policy reform proposals of the opposition during the 2002 election campaign, and in a number of points even went beyond them. Although the unions and the SPD had done what they could to water down its content, the declaration announced a series of measures that, if passed, would cut severely into social benefits and entitlements, for example by further reducing employment protection and limiting unemployment benefit to 12 months for most workers. It brought to a close a period of several months when Schröder appeared to be slowly gathering strength for a major change of direction, as implied at the end of the contribution by Streeck and Hassel. Indeed, on 3 March 2003 Schröder called a final meeting of the ill-fated Bündnis für Arbeit, only to declare it ended once and for all and advise the assembled representatives of unions and business associations that from now on the government would be legislating the necessary reforms on its own.

Behind this was a stratagem that can be understood only in the context of the intricacies of German federalism. Having failed to make the 'social partners' generate consensus policies that might then have been enacted with bipartisan support, the only way such support was to be had after the state elections of early 2003 was with policies devised against rather than with the unions. These, in fact, were the main losers of the new turn of events, together with the traditionalists in the SPD parliamentary party. Schröder's first term showed that an SPD chancellor cannot govern against the unions and the opposition at the same time. Since the unions could no longer be counted upon to deliver tripartite consensus, they were now pushed aside in pursuit of nothing less than a *de facto* Grand Coalition.

Why should the CDU/CSU let a Red-Green government that is at its mercy govern at all, even if it was dutifully executing opposition policies? Here Schröder seemed to count on pressure from business, less from its associations than from the CEOs of Germany's large firms, with whom he was always comfortable socialising. But there were also good party-political reasons that might have seemed convincing enough to at least some of the rival camps inside the opposition. Allowing the SPD to introduce the necessary harsh measures would mean that after a change of government in 2006 the CDU/CSU would no longer have to do so – and there is doubt whether, given the centrist tradition of the Christian parties, they could ever carry them out. The risk was, of course, that a successful SPD might be re-elected. Indeed, from a party-strategic perspective there might be equally good reasons to stonewall the government, let the crisis get even worse, and then take over and clean up.

On which of the two strategies the opposition would place its bets, and for how long, was difficult to predict at the time since that issue was intertwined with factional fights for party leadership in the forthcoming NRW and federal elections. It also depended on exogenous factors, like the development of the world economy. Moreover, it was entirely conceivable that eventually the SPD parliamentary party would balk and refuse to endorse legislation which by no stretch of the imagination could be defended as social-democratic – even though by deserting the chancellor it would very likely cause its own decimation in the 2006 election. In any case, the sort of change needed in Germany will clearly require more than temporary partisan configurations to make specific new policies rational in terms of electoral vote-getting.

Liberalisation has a variety of meanings, not all of which may be wholesome. But if institutional reform makes the centre of a political or

economic system release territorial and functional policy arenas from co-ordination and allow them to find specific solutions for their specific problems – rather than force them to wait for general solutions to be found together that are equally valid for and acceptable to all – then liberalisation is very likely the agenda to which both government and opposition must turn in coming years if they want to resolve the multiplicity of German crises. Decentralisation by necessity results in uneven change, which, in turn, may engender inequality. It may also lead to frictions between less homogenous actors and institutions, and perhaps to conflict and disorder. One way such conflict may be resolved is by competition, which may further increase inequality, at least until the losers learn to catch up with the winners. All in all, the outcome of competition is unpredictable, and so are the innovative ideas actors will come up with in their effort to survive.

A number of authors, foremost among them Peter Katzenstein, have described the ingrained incrementalism of the semi-sovereign political system of post-war Germany.¹⁸ Many of the contributors to this volume show how German incrementalism turned from a virtue into a vice when external conditions began to change rapidly. But then incrementalism is a problem only as long as uniform system-wide solutions are sought, and as tight coupling of system elements and narrow functional complementarity are generally accepted values to be enforced by joint decision-making. Basically that problem may be bypassed by decentralisation, freeing local or lower-level actors from burdensome obligations to take into account the effects of their action on other units and on the system as a whole. It is interesting to note in this context that it was also Katzenstein¹⁹ who observed that change in Germany, if it happened at all, would take place at the ground level of institutions that are hard to reform from the centre, and within which precisely for this reason actors may become quite inventive in changing their operation if not their structure. Liberalisation in the sense of decentralisation would build on this capacity by encouraging rather than constraining independent local adjustment – in the relationship, to name just two examples, between Bund and Länder as well as in the interaction between sectoral collective agreements and workplace-based Alliances for Employment.

Perhaps the reigning paradox of post-war German politics is that precisely because of the dispersed distribution of political capacities among a variety of actors which was the essence of German semi-sovereignty, actors have learned all too well to co-ordinate with one another to ensure social cohesion against the institutional odds. This would explain why in a

fundamentally multi-polar polity like Germany, institutional spheres and political decisions seem nevertheless to be so tightly coupled. Looser coupling would allow for more creativity from below, where creativity from above cannot be had because of the many 'joint decision traps' (Scharpf) and, today, because of simple problem overload. Again, for the sort of liberalisation that would make this possible, there would have to be more tolerance of diversity and uncertainty and less of the German *Angst* over centrifugal change.

Ultimately, we believe, the co-operative centre of German politics has no choice but to let go. In the same way, this applies to the national organisations of Katzenstein's 'centralised society'. The *politics of exception* under the *de facto* Grand Coalition that seemed to be taking shape in early 2003 would necessarily have to be, if it were to make a difference, one of decentralisation, to markets and local institutions, returning risks and gains to individual and collective actors at the micro-level, thereby enlisting their initiative and inventiveness to end stagnation and decline. The crisis being as profound as it is now, there may be a real chance that those championing liberalisation may for once escape electoral punishment, even though initially the strong will benefit more than the weak, who will have to give up entitlements to resources that must be diverted from subsidised consumption to innovative investment if German prosperity and social peace are to last.

NOTES

1. Just consider opinion polls at the time of this writing. Within months of the 22 September 2002 federal election, popular support for the re-elected Red-Green coalition collapsed after its announcement of a painful fiscal consolidation programme. But almost two-thirds of the respondents in the December 2002 ZDF *Politbarometer* survey rated the work of the CDU/CSU opposition as 'rather bad'. Almost as many respondents (58%) believed that a CDU/CSU government would not do better than the incumbent coalition. The Mannheim Forschungsgruppe Wahlen also found that citizen satisfaction with the opposition declined together with satisfaction with the government in late autumn 2002. See Deutsche Presse Agentur, 'Politbarometer: Wähler mit Rot-Grün so unzufrieden wie nie', DPA report of Friday, 15 December, 15:35 hrs: de.news.yahoo.com/021213/3/349g9.html.
2. For a detailed review of the institutional configuration characterising 'Model Germany', see Peter Katzenstein's *Policy and Politics in West Germany. The Growth of a Semisovereign State* (Philadelphia: Temple University Press 1987), which is still the most incisive and comprehensive summary we know. For a later account see Wolfgang Streeck, 'German Capitalism: Does it Exist? Can it Survive?' *New Political Economy* 2/2 (1997), pp.237-56.
3. See W. Streeck, 'On the Institutional Conditions of Diversified Quality Production', in E. Matzner and W. Streeck (eds.), *Beyond Keynesianism: The Socio-Economics of Production and Employment* (London: Edward Elgar 1991), pp.21-61.
4. G. Esping-Andersen, *Three Worlds of Welfare Capitalism* (Princeton: Princeton University

- Press 1990), and *Social Foundations of Postindustrial Economies* (Oxford: Oxford University Press 1999).
5. Estimates for 2003 are more even debatable than normally but all available alternative point in the same direction.
 6. Using levels of industrial employment in 1989 as predictors of change rates of employment in the ensuing decade (1989–98) and leaving out Germany and Japan, Germany's workforce in the industrial sector should have declined by 5.5% of total employment and Japan's by 5.2%. Actually, in Germany it declined by only 2.0% whereas in Japan it increased by 0.4%.
 7. Because large countries export less than small countries, we have taken out the effect of country size by regressing exports per million inhabitants on logarithmic population size for our 11 countries ($r = -.75$).
 8. For Germany's relative comparative advantage in different manufacturing sectors from 1961 to 1997, see H. Siebert and M. Stolpe, 'Germany', in B. Steil, D.G. Victor and R.R. Nelson (eds.), *Technological Innovation and Economic Performance* (Princeton, NJ: Princeton University Press 2002), pp.112–47, Table, p.120.
 9. For the link between market and technological challenges and the institutional advantages of different varieties of capitalism, see S. Casper, M. Lehrer and D. Soskice, 'Can High-Technology Industries Prosper in Germany? Institutional Frameworks and the Evolution of the German Software and Biotechnology Industries', *Industry and Innovation* 6/1 (1999), pp.5–20; P.A. Hall and D. Soskice, 'An Introduction to Varieties of Capitalism', in P.A. Hall and D. Soskice (eds.), *Varieties of Capitalism. The Institutional Foundations of Comparative Advantage* (Oxford: Oxford University Press 2001), pp.21–7; H. Kitschelt, 'Industrial Governance, Innovation Strategies, and the Case of Japan', *International Organization* 45/4 (1991), pp.453–93; D. Soskice, 'German Technology Policy, Innovation, and National Institutional Frameworks', *Industry and Innovation* 4/1 (1997), pp.75–96; and W. Streeck, *Social Institutions and Economic Performance. Studies on Industrial Relations in Advanced European Capitalist Countries* (London: Sage 1992).
 10. See Esping-Andersen, *Three Worlds of Welfare Capitalism*. For the current predicament of the conservative German welfare state, discussed in a comparative context, see F.W. Scharpf, 'Economic Changes, Vulnerabilities, and Institutional Capabilities', and A.C. Hemerijck and M. Schludi, 'Sequences of Policy Failures and Effective Policy Responses', both in F. Scharpf and V.A. Schmidt (eds), *Welfare and Work in the Open Economy*, Vol.1 (Oxford: Oxford University Press 2000), as well as E. Huber and J.D. Stephens, *Development and Crisis of the Welfare State* (Chicago: University of Chicago Press 2001), especially pp.144–68 and 223–40.
 11. See T. Iversen, *Contested Economic Institutions* (Cambridge: Cambridge University Press 1999), and R.J. Franzese, *Explaining Macroeconomic Policies* (Cambridge: Cambridge University Press 2002).
 12. P.A. Hall and R.J. Franzese, 'Mixed Signals: Central Bank Independence, Coordinated Wage Bargaining, and European Monetary Union', *International Organization* 52/3 (1999), pp.502–36.
 13. A similar process started in Austria about two decades earlier, when a long period of exclusion from government forced the Austrian People's Party (ÖVP) to rethink its Catholic cross-class strategy and move toward a sharper market-liberal appeal. It took, however, more than another decade of coalition government with the Social Democrats, and losses to the populist and anti-statist Freedom Party, to position the ÖVP firmly outside the old inter-party consensus on Austria's mixed economy with its large state sector.
 14. F.W. Scharpf, B. Reissert and F. Schnabel, *Politikverflechtung. Theorie und Empirie des kooperativen Föderalismus in der BRD* (Kronberg, Taunus: Scriptor 1976). See also F.W. Scharpf, 'The Joint Decision Trap. Lessons from German Federalism and European Integration', *Public Administration* 66 (1988), pp.239–78.
 15. B.R. Weingast, 'The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development', *Journal of Law, Economics and Organization* 11/1 (1995), pp.1–31.
 16. For a fascinating empirical confirmation of the democratic logic of inter-temporal

- accountability and responsiveness in the US case, see R.S. Erikson, M.B. MacKuen and J.A. Stimson, *The Macro Polity* (Cambridge: Cambridge University Press 2002), especially chapters 7 to 9.
17. H. Kitschelt, 'Partisan Competition and Welfare State Retrenchment: When Do Politicians Choose Unpopular Policies?' in P. Pierson (ed.), *The New Politics of the Welfare State* (Oxford: Oxford University Press 2001), pp.265–302.
 18. See Katzenstein, *Policy and Politics in West Germany*.
 19. In his edited volume *Industry and Politics in West Germany: Toward the Third Republic* (Cornell University Press 1989).

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