Ideas, Institutions and the Exhustion of *Modell Deutschland?*[#]

by

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Abstract

The paper will critically examine departures from decades-long prevailing patterns of economic policy in the German political economy since the 1990s. First, it situates the framework of Germany's political economy during the late-1980s and early 1990s. The primary focus here is an analysis of the domestic institutional structure of the apparently successful social market economy prior to unification. This section of the paper argues that German economic performance had surprised those who had advanced "Eurosclerosis" arguments during the early 1980s. Specifically, it refutes the belief that Germany's "model" economy would falter due to the apparent "sclerosis". Further, it suggests that this mistaken belief was based on a misunderstanding of the specific structure of the German economy and institutions. Second, the paper explains how three specific policy choices in the economic integration of the 5 eastern Bundesländer in the post-unification years have been a departure from expected patterns of industrial adjustment. It suggests that both private and public sector actors have embraced policies that were not only unsuccessful, but also departed from and undermined prevailing German industrial practice. The outcome of these failed policy choices — slow growth, higher unemployment, weakened export performance — also have raised sharp questions about the efficacy of the German model of organized capitalism and raised anew pressures for a departure toward a less "organized" and more Anglo-American set of policy styles. Third, the concluding section offers a critical policy analysis of the challenges facing the German political economy since the mid-1990s. It suggests that German policy makers, despite the challenges to the German model posed by unification, Europeanization and globalization, might reconsider their turn toward a very "un-German" pattern of deregulation. It concludes that whether this departure was intentional or unintentional in these unconventional policy choices, policy makers need to develop an explicit theoretical justification for their policies.

Introduction

The 1990s witnessed a critical re-examination of foundations the German post-WWII political economy. An institutional pattern characterized by: a financial system integrated with — and supportive of — export-oriented manufacturing, close coordination among private and public sectors (i.e. a "loose" corporatism), and a toleration — and acceptance — of highly skilled and highly paid workers with increasingly shorter work weeks, is under intense strain. Despite the generally superior economic performance from the mid-1980s to the early 1990s, the paper notes that the condition of the German model from the early to mid-1990s has not seemed to suggest an inviting institutional pattern to emulate.

Clearly, Helmut Kohl's center-right CDU/FDP government misjudged greatly both the economic as well as the political costs of German unification. Moreover, as impressive as German institutions have been for enhancing economic competitiveness and solidifying the social market economy, they assume — if not require — a relatively stable and predictable socio-political order. Here, the Kohl center-right government generally failed to provide the kind of basic institutional infrastructure which its center-right predecessor did in the early 1950s during an earlier period of major reconstruction. (Allen, 1989) What accounts for these policy "missteps" and why has there been a departure from form of the German pattern of economic and industrial policy making of the past two decades?

The paper will critically examine the German organized capitalist model since the 1990s in three sections. First, it situates the framework of Germany's political economy during the late-1980s and early 1990s. The primary focus here is a synthetic analysis of the domestic institutional structure of the apparently successful social market economy. The paper argues that this institutional model produced strong German economic performance and confounded those who had advanced "Eurosclerosis" arguments during the early 1980s. Specifically, the critics' belief that Germany's "model" economy would falter due to the apparent "sclerosis" was based

on a misunderstanding of the specific structure of the German economy and institutions. The main point of the first section is to stress that the German organized capitalism remained an effective, if poorly understood, model for economic adaptation as unification transpired.

Second, the paper moves to a more explanatory focus and shows how three adverse policy choices in the economic integration of the 5 eastern Bundesländer in the post-unification years have been a departure from expected patterns of industrial adjustment. It suggests that both private and public sector actors have embraced policies that were not only unsuccessful, but also departed from prevailing and successful German industrial practice. These three policy choices — combined with, or perhaps caused by, slow growth, higher unemployment, weakened export performance — also have raised sharp questions about the efficacy of German economic performance. More seriously, they have raised anew pressures for a departure toward a less "organized" and more Anglo-American set of policy styles. The paper explains why German policy makers apparently turned away from well-internalized and successful patterns of adaptation to deal with three specific problems specific to unification. In essence, German policy makers lost their "institutional memory" regarding their past successes during the *Wirtschaftswunder* with respect to the rebuilding of economic structures and economic policy. And because of this 'amnesia', found themselves open to Anglo-American policy options that have proven much less appropriate for Germany than the US and Britain.

Third, the concluding section takes a more policy-prescriptive direction and offers analysis of the possible durability of the socially constructed institutions so well nurtured in the Federal Republic since its inception. It suggests that policy must be guided by the fact that these institutions are characterized by <u>relationships</u> and not <u>deals</u> and thus require a process of ongoing negotiation among social partners to succeed. Yet, both the Kohl and Schröder governments seem to have departed from this pattern for apparently one of two reasons: either they were unable — or unwilling — to articulate an explicit, theoretical economic model; or had then become swayed by the apparently hegemonic Anglo-American patterns of implementing

economic policy. German policy makers — despite the quite real challenges posed by the triple shocks to *Modell Deutschland* of unification, Europeanization and globalization — need to rediscover the nuanced institutional relationships which enhance and enable public policy to function in the Federal Republic. But to do this, a clearer and more explicit conceptual model of their institutions must be developed.

The Institutions of German Organized Capitalism: Sclerotic or Adaptive?[+]

This first section of the paper establishes the foundational elements of the institutional structure of the German political economy. It's purpose is to establish a benchmark against which the policy choice "departures from form" can be measured in the second section. It will also serve as a reference point for the analysis and critique of the policy prescriptions in the third section.

For much of the early to mid-1980s, conventional wisdom suggested that the era of the "German Model" was over. The demise of the last Helmut Schmidt SPD-led government in 1982 apparently heralded a *Wende* that was more than just a change in political direction from the SPD to the CDU. Many observers also argued that the specific nature of German organized capitalism would also have to take a more *laissez faire* direction and that the entrenched institutions that gave the German model its identity were no longer effective. (Nussbaum, 1983; Olson, 1982) These authors — and others — looked to the more pro-free market policies of the Reagan and Thatcher regimes in the US and Britain as the more appropriate regimes for the 1980s. Critics argued that precisely the problems that seemed to beset the Federal Republic (bureaucratic institutions, oligopolistic industry, high-paid union workers, generous social spending) were amenable to the "solutions" offered by more market-oriented, privatized, deregulatory, and anti-union policies of the US and Britain. (Wilkes, 1984) By the mid-1980s, the conventional wisdom suggested that a dramatic change in the Federal Republic was necessary.

\+ Portions of the following are based on (Wever and Allen, 1992; Wever and Allen, 1993).

Yet such analyses proved wrong about the decline of the German economy. Despite alleged institutional rigidities, the German economy proved capable of maintaining its position as a export-oriented, high-wage, high-productivity country throughout the decade into the early 1990s. While talk of a *Modell Deutschland* may have disappeared with the end of the center-left Schmidt government in 1982, there was a substance and durability to Germany's organized capitalism that was not easily perceived. (Piore and Sabel, 1984) Without understanding the specifics of Germany's framework regulations and networks of relationships, it was easy to view the German political economy as "sclerotic". The primary cause for this misunderstanding was a considerable misunderstanding among many observers about exactly why and how Germany's flexible institutions supported the Federal Republic's competitive economy.

What were the components of this institutional arrangement? First of all, it was a system and not just a collection of firms and/or discrete policies. It has been a pattern of running a capitalist democracy in which business, labor and the government work together to develop consensual policy solutions to national, regional, state-level and local issues. The Germans have spoken of their "social" (not "free") market economy because there has been a deeply entrenched belief that business must share in the responsibility of providing a stable order, both for the economy and — indirectly — for society.

The foundation of this attitude was located in the fact that German business, labor and government embraced a different conception of regulation than the one used elsewhere. Rather than seeing regulation as a stark choice between *laissez faire* and heavy-handed regulation, Germany has used something called *Rahmenbedingungen* (framework regulation) which does not see a sharp market-state separation, or a single-focused goal of regulating each government action toward the market, but rather had a foundation of a looser, more encompassing framework for both the public and private sectors. This produced a system that is often called externally rigid (in the sense of prohibiting easy entrance and exit with respect to firms and industry) but internally flexible (in the sense that large institutions and firms are often — to American

observers — surprisingly flexible). (Hirschman, 1970) In short, this system regulated not the details, but the encompassing rules of the game within which all actors must play. To quote one of the founders of the Social Market Economy, Wilhelm Röpke, writing of the economic system that was established in the late 1940s:

> ….(our program) consists of measures and institutions which impart to competition the framework, rules, and machinery of impartial supervision which a competitive system needs as much as any game or match if it is not to degenerate into a vulgar brawl. A genuine, equitable, and smoothly functioning competitive system can not in fact survive without a judicious moral and legal framework and without regular supervision of the conditions under which competition can take place pursuant to real efficiency principles. This presupposes mature economic discernment on the part of all responsible bodies and individuals and a strong impartial state… (Röpke, 1982)

Both labor and business — together with national, regional, and local governments — supported an elaborate vocational education system and apprenticeship system. As the foundation for high quality manufacturing, these skill systems received attention as a reason for the apparent anomaly of a high wage — yet internationally competitive — economy. Clearly, the unions were entrenched in the economic and political life of the nation, including (and especially) the vocational education and apprenticeship system. To be sure, industrial relations rhetoric could be as conflict-laden as in Britain, and as chaotic as in Italy or France. But political compromise was far easier to achieve in Germany. Therefore, many observers associated the Federal Republic with industrial peace and social tranquillity, in large measure reinforced by the emphasis on worker education and skills.

In fact, the German political economy required a fair measure of social consensus. Industry's responses to changes in markets were almost always been endorsed by labor — by workers, works councils and unions. In highly visible public debates labor and business hammered out their differences about, for example, the length of the work week, the nature of codetermination (i.e. workers sitting on management boards) or the provision of both initial and ongoing training, as well as retraining for workers in declining or rapidly changing industries. Of course consensus at the national level presupposed a certain level of agreement about local

issues. This was achieved in Germany through plant- or workplace-level bargaining between local managers and works councils. The councils were nationally legislated, nonunion, democratically elected, blue- and white- collar worker representation bodies with broad rights to information about the economic situation of the plant or firm, to consultation about many types of organizational changes and with codetermination (veto) rights regarding basic personnel decisions including hiring, transfers, layoffs, and overtime. The councils relied on union expertise about the implications for employees of organizational change and industrial adjustment. (Wever and Allen, 1993) Largely because of this union influence, local negotiation between labor and management was generally brought into line with national developments. (Thelen, 1992) In so doing, the kind of national-local union fragmentation so common elsewhere, was largely avoided.

Labor influence in strategic matters such as investment decisions or new technology introduction was also considerable. In large firms strategic "codetermination" effectively allows for 49% labor representation on Supervisory Boards. As such, employees used "voice" that sometimes to some extent shaped strategic management decisions, and in any case they receive information about investment and other strategic plans at relatively early points in the planning stage.[1] In typical German annual reports, for instance, employees and the public at large were referred to as the major stakeholders in the company. Stock owners of any kind were rarely referred to at all.

The unions, their federation and the industry and employer associations commonly hammered out tacit agreements or even public contracts regarding most major public policy questions. Not only were German unions integrally involved in the definition and administration of the apprenticeship training system from the national level to the local, but they also played central roles in the development and implementation of various other labor market policies and institutions such as the transition out of noncompetitive industries and the establishment of

1. The receipt of this early information made it possible for works councils to develop proactive strategies that attempted to shape organizational change before it occurs, rather than simply reacting to management change initiatives.

employment agencies in the former East Germany. (Turner, 1998) Whether such institutions will prove sufficient in the early 21st century — in the face of growing employer reticence, EU harmonization and continued globalization remains to be seen.

Among employers, there was also a tight-knit sense of organization that is reinforced by national industry-wide institutions (*Bundesverband der Deutschen Industrie* – Federal Association of German Industry, or BDI), by employer groups (*Bundesverband der Deutschen Arbeitgeber* – Federal Association of German Employers, or BDA), and the *Deutscher Industrie- und Handelstag* – Chamber of Commerce, or DIHT). (Braunthal, 1965) These institutions were encompassing peak organizations that were more than just lobbying groups. Rather, they often framed issues for industries and individual firms via their research branches, as well as developed general strategies for international competitiveness and negotiated with governments at all levels on industrial policies. Although they were private organizations they were granted considerable power and responsibility to organize their members and shape public policy. They were more than simple interest groups in that they were explicitly chartered by the state to perform important public policy functions. As such, they also carried significant obligations to balance the priorities of international competitiveness against the need for social peace.

In part, these organizations also stood as a counterpoint to the highly organized and structured organizations of workers, developing collective bargaining strategies for entire industries and regions of the country. Moreover, these employer groups also had their sub-national member units that function at regional and local levels, further reinforcing the sense of an interpenetrated organized capitalism. These private sector organizations were augmented and reinforced by public sector agencies that took a "framing" role, (Katzenstein, 1987) rather than a "*dirigiste*" one.

This role of the public sector in framing, not directing, Germany's organized capitalism certainly applied to the Federal Government, but it also characterized the regional (*Länder*) governments as well. For one thing, the economic problems that developed in Germany after the

first oil shock in 1973 were much more sector- and region-specific than they had been during the postwar reconstruction period. (Hueglin, 1986) For another, the coming to power of the center-right Kohl government in 1982 meant that the Bonn government was less willing to intervene in economic affairs than were the SPD-led governments of Willy Brandt and Helmut Schmidt from 1969 to 1982. Regional governments in the 1980s began to take increasingly active steps on their own. They somewhat less successfully pressed the federal government for increased aid and coordination and implored the federal system to prevent the reductions of certain subsidies for hard-hit industries. (Fach, 1990) Taken together, these policies laid to rest the "Eurosclerosis" arguments of the early 1980s, (Olson, 1982) as the Federal Republic's economy retained by the beginning of the 1990s the third highest GNP of capitalist countries behind the United States and Japan (with one-fourth the population of the former and one-half the population of the latter). These policies enabled the German economy to combine order and adaptation — a kind of "shared capitalism" — in ways that both free market and statist analyses would not recognize.

The other key component of the German political economy — the financial system — was dominated for years by a small number of huge universal banks (Deutsche, Dresdner, and Commerz are the largest) — universal because they perform <u>all</u> financial functions — that have enjoyed wide latitude, as the Federal Republic of Germany needed to rebuild rapidly after WWII. This caused policy makers in the new Bonn government to draw on earlier 19th century patterns that could allocate large amounts of capital quickly and effectively. Unlike the American system, there has been no detailed regulation that produced a separation of financial functions. The banks have been free to own stock, sit on boards of directors, vote large numbers of proxy shares, and make long term loans to most firms, large and small. The link between great institutional power and the investment needs of individual firms has given the banks a great financial responsibility toward the country's overall economic health. (Shonfield, 1965) In general, the German postwar preference for monetary stability has greatly reduced the desire for speculation that has often characterized aspects of American finance. However, despite some evolution during the 1980s

which diffused the earlier “one firm-one bank” (i.e. “house bank”) relationship German industry evolved from a tight toward a more loose system of “organized finance capitalism”. (Oberbeck and Baethge, 1989; Esser, 1989) Despite the evolution of “house banks” to “banking networks”, (Deeg, 1998) there still remained — particularly in the small and medium-sized firms and banks — a German preference for long term-oriented investment, the presence of the banks on company boards, and the interpenetration among leaders of industry and finance. Despite the global visions of the Deutsche Bank, the links between financial organizations and manufacturing firms have deeply embedded the long-term significance of banks in the German political economy.

In short, many German banks remained an integral component of economic growth.[2] The international wave of financial deregulation of the early 1980s never took hold in Germany below the level of the large banks. The banks — at levels below the most visible — are still “universal” in that they can perform all banking functions, rather than limiting their activities (along the American model) to relatively narrow realms (i.e., mortgages, commercial loans, etc.) Together these factors effectively excluded private individual shareholders from strategic decision-making forums.

Moreover, the banks have maintained a system of self- regulation and self-insurance that requires much regular interaction and reflects their status and self-conception as major and responsible actors in a larger system. Taking on this responsibility has enabled them to develop a private self-insurance system which has suffered far fewer losses than the public F.D.I.C. in the U.S..

Taken together, these institutional patterns have proved more encompassing, durable and effective than many critics asserted. [3] The combination of the framing regulation, social partners,

2. The contrast to the U.S. and British equities trading systems was particularly sharp. For instance, in 1987 shareholders’ equity as a percentage of total equity in manufacturing companies was 43% in the U.S., 46% in Britain and 27% in Germany. Source: O.E.C.D., National Accounts, Various Years.

3. For an excellent theoretical treatment of dynamic institutions, see: (Steinmo *et al.*, 1992)

organized business (especially small business), and a strategic system of long term finance represented values to which many countries aspire.

The traditional success of this model of institutionalized adaptations raises some profound questions for the remainder of this paper: Is this system durable in the wake of the continued imbalance between east and west, the continued encroachment of EU encroachment of German-specific industrial patterns (i.e. the Euro, harmonization of industrial patterns on anglo-american patterns, and continued globalization)? If so, what explains the apparent departure from this pattern toward more deregulatory forms in three specific post-unification policy ares? And are the Germans still interested in — or still capable of — rediscovering their organized capitalist pattern and challenging the more prevalent *laissez-faire* models characteristic of industrialized countries since in the 1990s?

German Economic Policy after Unification: A Tale of 3 Unexpected Choices?

But just as the conventional wisdom was wrong about the demise of German industrial competitiveness during early and mid-1980s, so too was the "new" conventional wisdom in the early 1990s of a smoothly functioning German economic juggernaut. Among the primary reasons for this judgement are that: the Kohl government badly misjudged the costs of unification and the institutional resources necessary to integrate the five new *Bundesländer*; the nature of the structural challenges which the German economy faced since the mid-1990s were far more extensive than any that the Federal Republic had experienced since the 1950s; and the German-specific nature of their institutions (even when working well) became difficult to impose on — or even transfer as a model to — its eastern German regions.

The Kohl government misjudged drastically the costs of unification. By mid-1992, Kohl finally acknowledged what had been apparent for several years; namely that the successful integration of the eastern economy into the western one would cost much more than originally predicted and require a longer period of time to do so. (Bering, 1992) The amount budgeted in

the Bundestag budgets in the early and mid-1990s for reconstruction in Germany regularly exceeded 20% of the entire FRG budget. In addition, funds from private firms, regional governments, and other subsidies amounted to another billions of DM more, yet it did not seem to be enough to make the assimilation process go more smoothly. (Neckermann, 1992) There remained a large gap in the productivity levels between the two regions, and the *Treuhand* (the government reconstruction agency) quickly privatized some 7,000 of the total of 11,000 firms that it had taken over. One of the most significant of the costs of this transition was the high unemployment in the former Eastern sector. Some 1.2 million persons were officially unemployed, and another 2 million have been on a government-subsidized “short-time” program that is combined with job training centers. Yet the latter program had its funds cut as part of this “austerity” budget.

Some pessimistic observers began to suggest that these stresses placed the German political economy in a precarious position. Germany’s economic prowess has resided in certain manufacturing industries whose goods may be eminently exportable, but many of whose technologies are decidedly “low” and the costs of wages continue to rise. The costs of the “social” market economy, as witnessed by the costs of unification, pressed on the upper limits of Germany’s capacity to pay for them. Massive budget cuts — far higher than even imagined in 1992 — became imperative by the Spring of 1993. The completion of the EU — supposedly the grand culmination of a post-cold war spirit of German and European unity — proved ephemeral at least for the short term. Its only immediate benefit were to strengthen the trends toward decentralization and deregulation already under way in Western Europe. More significantly for the German policy makers, it seems to have disturbed the organized capitalism of Germany’s small and large businesses. Plus the apparent deregulation in European finance threatened Germany’s distinctive finance/manufacturing links. In short, the trend toward Europeanization — in a way that challenged Germany’s pre-eminent position, and did not produce hegegemony — seemed incompatible with the highly consensus-oriented and coordinated nature of Germany’s adjustment patterns.

In addition, tensions arose between the former East and former West Germans. While easterners resented the slow pace of change and high unemployment, western Germans have been bitter about losing jobs to easterners and paying — through increased taxes — for the cleanup of the ecological and infrastructural disaster inherited from the former East German regime. Also, racism once again has returned, often in the form of violent attacks on Asians, Turks and others who "look" foreign. (Roberts, 1992) The two major parties — Christian Democrats and Social Democrats, and particularly the Chancellor — failed to take the kind of strong action against the neo-Nazi groups that have come to characterize most postwar German leaders.

What seemed most surprising to many observers sympathetic to the "organized adaptation" view of German patterns of adjustment was the Kohl government's — and the private sector's — inability to "return to form". By this I mean the pattern of providing a basic investment-oriented economic foundation together with a "safety net" for those most hurt by the transition. The model, of course, was the *Wirtschaftswunder* and the *Sozialemarktwirtschaft*. (Grande, 1987) Drawing on these two specific phenomena, should not imply that they could have been somewhat magically re-created 40 years after their original appearance. However, certain policies pursued by both private and public sector actors in the early 1990s seemed to belie the institutional memory which quite likely still resides within the institutions.

Taking a deeper look at the reconstruction of the former GDR, allows some interesting observations. First, why was there not a greater emphasis by both the private and public sector in favor of basic investment goods and infrastructural public sector investment? To those who have studied the process of rapid German industrialization in the 19th century and the process of rapid German re-industrialization during the *Wirtschaftswunder* years of the 1950s, the period of rebuilding the former GDR offered some revealing comparisons. It is clear that private and public officials should have had both a clear idea and the institutional capacity to undertake this process. (Wallich, 1955; Erhard, 1962) In fact, several retired banking officials from the three

large German banks (Deutsche, Dresdner, and Commerz) were called out of retirement to serve as consultants to contemporary banking officials. Precisely because they had direct experience during the *Wirtschaftswunder* in introducing a new currency, handling massive amounts of industrial investment, and creating a network of business services, there was an institutional memory that promised to stand the economic reconstruction process in good stead. In other words, there were mechanisms in place to aid in the rebuilding process as, in a very important sense, this was not a new exercise. Since the economic problems remained daunting, the mystery was why more appropriate — and less politically expedient — policies were not pursued.

Property Ownership

One of the first set of policy mistakes made that departed from “form” in the five new states was the basic issue of providing the foundations for fixed capital investment. Take the example of property ownership. Before investment could take place in the former GDR, some clarity on title to property was needed. This was complicated in three ways. Not only was the issue of property taken during the years of the GDR (1949-1990) an issue, so too was the confiscations that took place under the Soviet occupation of the former GDR (1945-1949) and those that took place during the years of Nazi occupation. With this basic issue unresolved, economic growth and investment remained stalled throughout the early 1990s. The most difficult aspect of this issue — at least for the Kohl government — was that of compensation. The unification treaty stated that any compensation for property taken had to be paid at “current market value.” The problem with this formulation was that the 5 eastern *Bundesländer* were just establishing a market system and the value of particular properties varied widely in these states, depending on whether surrounding property had begun to be developed or not. However, the treaty also stated that a slightly less difficult option might be available, namely that the confiscated property could be returned to its owners.

If the issue of personal property was problematic, the situation for commercial property was a only a little less difficult. While some private western German firms made major commitments to invest, substantial productive commitment of private resources remained low. The two industries that moved more quickly physical capital investment were two mainstays of the western German economy: machine tools and industrial electronics. While massive reinvestment was necessary to make machine tools a profitable sector in the five new *Länder*, many observers felt that there was at least a solid foundation to build on. With respect to electrical goods, the giant firm Siemens was potentially in a strong position in both industrial goods as well as consumer goods. Siemens primary strength has been in telecommunications and the needs for creating a modern telephone and communications system were daunting. In fact, a large among of the Siemens funding for this investment would be coming from the Federal Government. Siemens, a maker of electrical appliance and computer equipment, also was expected to find large demand for its consumer goods. Yet, aside from thee initial interest from these two sectors, rapid growth did not follow.

The question here is why was not the property ownership situation handled more expeditiously? In other words, basic investment in industry and infrastructure requires clear title to property for needed investment. Yet the policy choices by the Kohl government acted to postpone the smooth resolution of this issue. Why?

Currency Reform

A second basic policy departure was with respect to currency reform and the solidification of an appropriate set of "social market" policies. The primary problem for the Kohl government was that of massive investment needs for such basic functions as telecommunications, transportation, and environmental cleanup. Research institutes estimated that the total public sector investment needed to rebuild the 5 new *Länder* would total in the hundreds of billions of DM during the early 1990s, with large portions of that sum going to the ministries of

Telecommunications, Railway, and Environment. The basic issue that flowed from these needs was how this was to be paid for. For most of the early 1990s Kohl had argued that new taxes were not necessary to pay for the reconstruction and rebuilding costs of the integration of the former GDR into the Federal Republic. (Neckermann, 1992) The realities of unification, however, left the government no choice.

Yet when the old East German Reichsmarks were exchanged for DM, there was a much more consumption-oriented policy than was the case in the 1948 currency reform. Rather than the policy of 1948 which explicitly favored property-holders, the Kohl policy produced many more immediate consumer benefits, and far fewer incentives for investment. Due the to the human costs of this economic inequality between the two regions, Kohl chose to embrace a policy that was painless in the short run, but problematic for the long run. Many of the subsidies that GDR citizens had enjoyed were gone. Among these were housing allowances, low cost health care, subsidized day care, and low costs for such basic services as public transportation. While wages were low in the former GDR, costs were also low and workers did not have to suffer from unemployment in the western sense. There was considerable overstaffing in many firms, for which east Germans paid dearly, but destitute individuals were not roaming the streets as is the case in many affluent western societies.

The votes among former GDR citizens during the many elections of 1990 would suggest that they were willing to give up the meager certainty of GDR life for the greater freedom and opportunity of the west. But with this opportunity also came considerable cost. While former GDR citizens did exchange their own currency at favorable rates, the costs for many basic services such as housing and health were considerably higher under market conditions. In addition, the wages that workers in the 5 new *Bundesländer* lagged considerably behind workers in the west. For example, railroad workers in the now unified state railroad were paid different wages depending on whether they were based in eastern or western Germany. This remained a contentious issue in numerous industries throughout the decade. (Silvia, 1997) Not surprisingly,

this produced strikes within three years, as the employers and government reneged on some of these promises.

To be sure, the immediate pressures for providing a close to parity exchange rate were powerful. However, the mystery here was why were not more investment-enhancing choices made with respect to currency reform. They could have been combined with a "new social market economy" that might have more realistically anticipated the length of time necessary for the "catching up" of the former GDR. After all, the *Wirtschaftswunder* took the better part of 10 years to come to fruition. In other words, here was a second policy choice that differed from long-standing German patterns. Why?

The *Treuhand*

A third set of policy choices was also a departure from form, namely the formation of the *Treuhandanstalt* (Trusteeship Agency). While it was part of the institutional legacy of the GDR, the Kohl government did nothing to harmonize the *Treuhand*'s "mission" with the prevailing institutional norms of FRG economic policy making. The *Treuhand* took a different philosophical position with respect to the relationship between state and market than was the norm in Germany. Most economic policies in Germany — with the most notable and egregious exception of the Nazi period — tried to avoid sharp "state vs. market" choices. In fact, the precondition of the German political economy since the late-19th century was the sense of "framework regulations" (*Rahmenbedingungen*) in which the state created a stable outer boundary — within which all actors had to play — but then allowed large amounts of flexibility and freedom "within" the framework. We can contrast this model with that of the US (and other *laissez-faire* oriented polities) where the opposite vision was present. Namely, there is a preconditional assumption of "limitless opportunity" in the market, and only sees the state stepping in to regulate the specific "market irregularity" which most recently occurred.

The *Treuhand*'s operational philosophy seemed much more akin to the "state vs. market" philosophy of regulation then it did to the more "normal" German pattern. Rather than carefully evaluating which firms — and their supplier networks — might serve as a foundation for new growth, the *Truehand* took a much different "scorched earth" approach. (Kern and Sabel, 1991) The operational assumption was that few, if any, of the former firms were worth saving. Therefore, the only option that logically followed was this "scorched earth" rapid privatization of as many firms as possible. The effect of this policy was to undercut the potential formation in the five new *Länder* of the kind of institutional pattern upon which the former West Germany had relied.

Moreover, the *Treuhand*'s hegemony distorted and undercut the coordination between the governing coalition partners necessary to produce effective, specific policies. The FDP as a more free enterprise party, wanted to make the former GDR a "low tax area" in that sense, somewhat similar to the demands in the United States by some free-marketers for "enterprise zones". The CDU preferred to give more targeted tax concessions to those firms and individuals that would make commitment to invest in the eastern states. While the goals would be somewhat similar, the debate bespoke a more philosophical disagreement about whether *laissez faire* conditions should be created (FDP) or whether the state should maintain a more guiding hand in the transition to capitalism in the form of specific tax breaks for specific types of investment (CDU). There was also a dispute between the CSU on the one hand and the CDU/FDP on the other on the issue of rent subsidies. The CSU wanted to guarantee that rent increases in the eastern states should rise no more that 15% over 3 years while the CDU and FDP wanted the figure set at 20%. The CDU position prevailed.

With these basic policy choices made, the significant departure from the pattern of basic German foundational principles seems evident. Kohl had sold unification well and many former GDR citizens wanted to look forward not backward, which explains the wholesale lack of support for the parties of the left. But this "selling" of unification took place at tremendous cost.

In retrospect, it his not only with the advantage of "20-20 hindsight" that these policies can be criticized. They were clear departures from policy options which had produced proven results over time. Consequently, it is not surprising to see the low ebb of political support for the center-right government in the face of the economic and political dislocation that followed. The question here is why this very "un-German" state vs. market set of choices was made rather than the more expected "quasi-public" one?

Germany and the "Siren Song of Deregulation."

Does the preceding account of these three "departures from form" suggest that Germany began to change its system of organized capitalism during the Kohl years? Has it now responded to this challenge by moving toward a more Anglo-American deregulatory model and embraced even by the Schröder governments since 1998? These are the kinds of policy suggestions that will likely emerge as the Federal republic faces its most severe and challenging economic conditions. One of the most effective responses in the past which Germans — from both the private and public sector — could make in response to the siren song of *laissez faire*, privatization, and deregulation was that those options were not needed because the German system "worked". This assessment now seems much less applicable than it has been since the days of the beginnings of the *Wirtschaftswunder*.

Does this mean then that the unique form of the Germany's political economy (organized, flexible capitalism with active state presence but not *dirigism*) has expired? This concluding section asks whether such a conclusion is warranted, but it also suggests reasons why the Kohl government's three policy choices took their unexpected course. Despite the quite formidable strains facing Germany's political economy, the central argument of this paper is that the German form of organized capitalism may still be a more useful response for Germany than a deregulatory anglo-american model that Germany has never been very good at emulating. The primary reasons for this conclusion are visible if one examines: the core foundations for

sustained economic growth; and the socially constructed institutions that need to support it. Yet such an approach does not emerge or continue spontaneously, it requires an theoretical and practical understanding of its essential features by its practitioners.

Core Foundations for Economic Growth

Several authors offer evidence that the specific functions performed by German organized capitalism: patient, long-term oriented capital investment; the importance of goods — and not just services — production; and high skilled, workers are still a necessity for any internationally-competitive economy. Despite fundamental challenges, these components of the German system are largely still present. (Yamamura and Streeck, 2003) It remains for political and economic actors to realize where their strengths are. They should resist being swayed by policies which promise much but which have proved questionable even in the countries where they have been most enthusiastically embraced.

For example, Lowell Turner offers a contemporary example of the challenges that face Germany in the labor market arena and suggests that there are explicit choices that can produce adaptation in a pattern recognizable to the German political economy. (Turner, 1997) Adjustment challenges are more sharply defined in the eastern part of Germany than in the western. Turner suggests that local diversity may be nowhere more critical to successful restructuring, and his research indicates that local "outcomes" are indeed very varied. he describes a continuum from a "polarization" to a "modernization" scenario, and argues that both are equally possible at this historical moment. "Polarization" occurs where management tries to profit at the expense of high labor standards. Modernization is where labor is integrated into a productive and flexible partnership that takes advantage of the latest organizational and production innovations and new technologies. His interviews with management, union and works council representatives in the former East Germany leads him to conclude that there is no reason why unions should not be able to influence employers in the direction of the

modernization approach. However, the time, effort and resources devoted to mobilizing this German institutional capacity to address these changes will require supportive policies in other areas as well.

In addition, the production of high quality manufactures for export relies on the existence of a highly skilled workforce. (Sandholtz and Zysman, 1989) The existence of that workforce is unthinkable without extensive apprenticeship and retraining and further training mechanisms. These in turn function only on the basis of close consensus between the “social partners” who shape and administer these programs. That consensus hinges on the strong position of the unions in both regional and industry-level bargaining and in joint business-labor decision making forums at the federal, state and local levels. This coordinated and centralized approach to policymaking would not be possible in the absence of powerful and pervasive employer and industry associations which speak for member organizations in reaching agreements with the unions and the government on all important matters of public policy. Centralized industry associations are able to act cohesively in part because of the banks’ detailed involvement in strategic management decisions about long term investments, which enables firms to focus on the long-term collective good of the economy as a whole. (Lazonick, 1991) Despite all the apparent deficiencies of German economic policy — as the current conventional wisdom would have it — it still addresses specifically the core functions that any competitive economy must perform.

The problem in responding to the more transparent free-market oriented arguments, is that the German-specific nature of the institutions are too immobile to serve as a “counter-model”, at least in the specific form they take. (Jacoby, 2000) In other words, the structure that has produced such a strong and adaptable economy does not “travel well” — not can it be “empirically well tested” elsewhere in response to its critics.

Ultimately, however, the key to any future success of the German political economy is that its structure (made up of public, public- private and private sector institutions) remain flexible enough to accommodate significant changes in its content (politics and strategies). This political

and social flexibility only works under circumstances where all major societal stakeholders — including employees and their representatives — are guaranteed a central role in carrying out the processes of social and economic change. (Deeg, 1994) Only under these circumstances can the main social "actors" — business and the state, from the local level to the national — work together to develop and implement solutions that support the common good.

Socially Constructed Institutions

The future of the German organized capitalist model is that socially constructed institutions of the political economy are interposed between the free market and the parties interacting within it.[4] These institutions foster relationships rather than deals. Deals cannot tolerate changes in the environmental circumstances in which they are made. That is why they must be subordinated to legally enforceable rules. Relationships, on the other hand, can be sustained by ongoing negotiations and tradeoffs, allowing for what Kathleen Thelen calls "negotiated adjustment." (Thelen, 1992) But these relationships can only survive in the presence of a coherent framework that recognizes and supports distinct and frequently conflicting social and economic interests.

While many countries stress the need for adaptive institutions, effective ones are not created easily. For many countries that might try to emulate competitive institutional patterns from Germany — at public, private, local, state-level, regional or national levels — they will be new creations. (Soskice, 1991) But German patterns of framework regulation, institutionalized worker participation, vocational education, coordinated organized capitalism, and long term oriented investment developed in Germany over decades.

Actors in eastern Germany that might see the value of emulating FRG institutions require not just strategies but also the means of implementing them. The lack of a cohesive institutional framework would severely hinder efforts to develop strategies appropriate to meeting the

4. I would like to thank Peter Katzenstein for helpful suggestions that have helped refine the exposition of this concept.

domestic and international challenges that these *Länder* face. Actors in the eastern states know the goals to which they must aspire, namely a highly skilled workforce able to compete in international markets on some basis other than a combination of low labor costs and high tech production strategies. (Streeck and Schmitter, 1991) But whether they can or want to emulate the western German model remains to be seen.

The paper has argued here that the departure from expected policy form in three areas has robbed German policy makers of their most durable and successful tools for rapid and successful economic growth. Specifically, the institutional structure which has incorporated capital, labor and the state in a broad regulatory framework that "bounds rationality", minimizes exit and maximizes voice was clearly a path not taken by the Kohl government in the 1990s nor the Schröder government more recently.

The mystery is whether this departure from expected action was deliberate or unintentional. If it was deliberate, perhaps was can infer that both of these German governments — like many western European governments who embraced mixed economies throughout the postwar period — became seduced by the siren song of deregulation — and concluded that the old German system was not longer applicable. If it was unintentional, it suggests that German policy makers have lost their "institutional memory". If so, these "grandchildren" of the Adenauer-Erhard regime have now made their ancestors rest much less easily than they used to.

There are at least two plausible arguments that might account for the inability or unwillingness for German policymakers to articulate and tout a renewed form of German organized capitalism for a unified Germany.

One might be a legacy of the "economic giant/political dwarf" phenomenon of the 1960s-1980s period. During that time, Germany (like Japan) could pursue economic growth as a first priority without having to worry about international political responsibilities. Yet in the 1990s, with a unified Germany and the end of the Cold War, was Germany prepared to advance

an explicit and specific "model" for transformation of formerly communist regimes? There were many Europeans who might look askance at such an enterprise. In other words, perhaps the Germans avoided talking about a model themselves because of the historical baggage that such a discussion would generate. Maybe it was much easier to "sell" the German pattern of industrial adaptation if it was not perceived as a new form of German hegemony. In other words, pragmatism may have won out over an explicit discussion of ideological forms of economic adaptation.

There is also a second plausible argument that many German policy makers have indeed be heavily influenced by Anglo-American patterns of domestic policy making. These patterns have been reinforced by the increased internationalization of all economies. However, a more likely explanation can be advanced that an unintentional "departure from form" has been at work. As the best of the new institutionalist literature (Steinmo *et al.*, 1992) has argued, institutions are not just fixed structures. They are dynamic entities which — at their best — are embodied by purposeful policy makers and patterns of understood responses to a wide range of policy outcomes. Yet these responses are not spontaneously-occurring phenomena. They need to be understood, reinforced and continually tested against new challenges if they are to retain the capacity to produce suitable economic policies. But because the German model of organized capitalism has seldom been touted as an explicit ideology, the German policy makers who have internalized this pattern of behavior — but rarely discussed it explicitly — may be less able to defend its merits when attacked by adherents of deregulation and *lassez faire*. In numerous interviews with German officials in both the private and public sectors, researchers have reported that patterns of responses are often more intuitively understood than explicitly discussed. In one sense, this might suggest a beneficial shared understanding of a range of suitable responses. However, it also might indicate an inability to actually understand how to use past, prevailing institutional patterns with contemporary problems.

In short, for Germany to build — or rebuild — institutional coherence to respond to such policy choices as outlined above, the precise role of these institutions must be discussed and understood, not just intuited.

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