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Economic and Political Governance in Germany's Social Market Economy

by

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Abstract:. Germany's system of economic and political governance strongly relies on group decision-making and consensus to solve economic issues. This approach relates to a wide spectrum of decisions, including the social partners with the trade unions and the employers' associations in wage formation, the trade unions in the governance of firms through codetermination and the workers' councils in the operation of firms, but also to relationship banking and to the steering of the university system by codetermination and by a governmental planning approach. In addition, in the governance of government and its federal structure, mechanisms of consensus are an important feature, above all through the joint responsibility of the Bundestag and the Bundesrat in law-making. Distributive federalism is another expression of the consensus mechanism. Looking at all these mechanisms, it is surprising how strongly the market economy is restrained in Germany.

Keywords: Codetermination, governance, consensus, group decision-making, governance of the universities, governance of government, voting system, Bundesrat and law-making, distributive federalism.

JEL classification: D72, G3, H1, H7, J5

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Economic and Political Governance in Germany's Social Market Economy

Germany has developed a system of governance in which, besides markets, non-market mechanisms to find a consensus and to solve economic issues play an important role. Markets are used as a coordination and allocation devise, but they are partly substituted by the decision-making of social groups and by informal personal relationships. This approach to governance includes the social partners with the trade unions and the employers' association in wage formation, it comprises the banks, the workers and the trade unions in the governance of firms through codetermination, where in addition block holders have strong positions, and it involves the workers' councils in the operation of firms. The approach also contains informal personal relationships as in the bank-based capital market with intermediated products. But it applies to other areas as well such as the regional associations of statuary health insurance physicians in the public health system and to the steering of the university system by codetermination and by a governmental planning approach. Moreover, market outcomes are corrected or influenced by a set of policy instruments. Germans look for consensus and seem to have some preference for non-market solutions. In addition, in the governance of government and its federal structure, mechanisms of consensus are an important feature.[1]

The Role of Markets

In the product markets, Germany relies on the market mechanism in order to coordinate the decisions of households and firms, to stimulate technological innovations and to bring forward new solutions to problems in a decentralized

[1] I aprreciate critical comments from Terhi Jokipii, David Moore, Eduard Herda, Eirik Jones and Bennedikt Wahler,.

way. As the country is an open economy and as openness has been a basic principle of German economic policy that never really was put into question, firms are free to compete. The need to produce internationally competitive export goods in terms of quality and price and the necessity for domestically produced goods - the import substitutes - to stand up to the imported products of other suppliers in the global market, are important reasons for the fact that the product markets of tradeables are interfered with the least by government intervention. In addition to this aspect of openness, competition policy has a long tradition in German economic policy; it is to make sure that large firms cannot dominate the market process, that market power is not misused and that mergers leading to monopoly-like constellations are prohibited.

Since the late 1980s, privatization has taken place in the areas of telecommunication, the postal service and the railroads. To some extent municipalities sold their equity in regional public utilities in electricity and water supply; partly local transportation and garbage collection have been outsourced by auctioning these activities off for an operating period. The government, among it some of the Länder, has sold or is selling its equity in firms, for instance in telecommunication and power transmission. Moreover, former stiffly regulated markets were liberalized and new property rights were defined for the network industries including telecommunication, power transmission and the gas industry so that together with a new regulatory regime the old “natural” monopolies in the above mentioned sectors have been abolished.

Other product markets, however, are characterized by strong government intervention; the market is restraint. Modern sectors like biotechnology and pharmaceuticals are regulated by a licensing procedure of new products, requiring time and thus causing costs that do not arise in other countries. An exit

program from atomic energy with a time table for the closure of individual nuclear power plants has been set up; this was done in agreement with the atomic industry which in exchange got the certainty that the plants could run up to the agreed dates. Other regulations relate to operating permits for plants and building permits. Generally, it can be stated that in Germany economic activities in most areas are regulated in minute-detail; extensive permits have to be obtained in advance of actual investment, and regulations have to be satisfied. Store closing hours in Germany are strictly limited, which obviously constraints consumer freedom and entrepreneurial options.

In yet other product markets, prices are controlled like in housing and apartment rents; the regulations specify the permitted increase in these rents and define the entitlements of the tenant such as his protection against a notice. This, however, does not apply to office space. Since housing belongs to the sector of non-tradeables, this type of regulation does not have direct international repercussions. However, the regulation reduces incentives to supply apartment space and to invest in the housing sector. The decline of the West German construction industry since the 1990s is likely to be partly caused by this regulation. A measure of the intensity of regulation is the index of prices administered and influenced by government; 30 per cent of the prices in the consumer price index are regulated in some way. This expresses the high government influence on the private sector in the product markets. Moreover, some of the goods markets are heavily affected by subsidies. This holds for agriculture, coal, ship building and nowadays also for alternative energy such as wind mills and the cogeneration of power and heat. The subsidies in agriculture are to a large part taking place within the context of an EU-framework.

Factor markets are more intensively regulated than the goods markets. The bank-based capital market is segmented into the three-pillar system where the

savings banks together with their head institutions and the cooperatives, one of the other pillars, are protected against take-over by other banks. Under these circumstances corporate control cannot function. In addition, there are public banks completely owned by government. Only the commercial banks with a market share of merely 28 per cent are exposed to full competition. No wonder that competition in the banking industry is distorted and that the rate of return in the industry is low when compared to other countries.

The most intensively regulated market is the labor market. Many regulations influence the supply of labor by workers, the demand for labor by firms and the equilibrating mechanism of the labor market. This relates to lay-off constraints, reducing the demand of firms for new employees, as they are afraid not to be able to lay them off in the next recession. It also applies to an informal minimum wage determined by the social security benefits. This prevents a market-clearing wage and dries up the lower segment of the market. Additionally, it compresses the wage structure. How little market orientation is present in Germany can be seen from the fact that in the reforms on unemployment compensation of type II, the Schröder government even intended to formally introduce a minimum wage (in the form of the wage agreed upon by the social partners) for the social welfare recipients capable of working; only if this wage were offered would he or she have to a accept a job offer. And, of course, labor market regulation refers to the right of the social partners to set the wage without being made responsible for the volumes that will result in the labor market, i.e. employment and unemployment. This apparently is the most obvious deviation from the market process. It is naïve from the point of view of basic economics to expect a market-clearing equilibrium under these circumstances. If one fixes a price in a market, demand and supply will react. There are not too many reasons why the social partners, naturally guided by their self-interest, are likely to find the market-clearing equilibrium price that brings full employment for the economy.

In addition, labor market institutions, which protect the insiders and their wage contract including the wage rate, restrict market access for the outsiders thus raising the rents of the insiders and causing unemployment to the outsiders. Moreover, the trade unions can be tempted to rely on governmental schemes to reduce unemployment, i.e. to be bailed out from their responsibility by a third party, namely the state and the taxpayer. In essence, labor market rules can be interpreted as protecting the wage cartel and securing the power of the trade unions.

Codetermination in Corporate Governance

In several aspects, Germany has chosen a distinct approach to the control and the management of firms, commonly referred to as corporate governance. Important differences exist relative to other countries in the entire range of mechanisms and arrangements that shape the way in which key decisions are taken within companies. First, a special feature of German corporate law is the separation between a supervisory board (*Aufsichtsrat*) and a management board (*Vorstand*) in stock companies, as discussed in another working paper. Second, banks play a vital role in the controlling of firms due to the dominance of intermediated products and along with the banks' position in the supervisory boards. As indicated by the term "housebanks", informal or personal relationships are relevant factors, the reason being the lack of alternatives to these mechanisms of allocation, namely market products. Third, in contrast to the system in operation in the more stock market-based economies of the United States or the United Kingdom, block holder representation in the supervisory boards is much more pervasive within the German system. Fourth, another decisive specialty is that employees and the trade unions represent half of the votes in the supervisory board of incorporated companies with more than 2000 employees; it is one third of the votes in smaller incorporated companies above

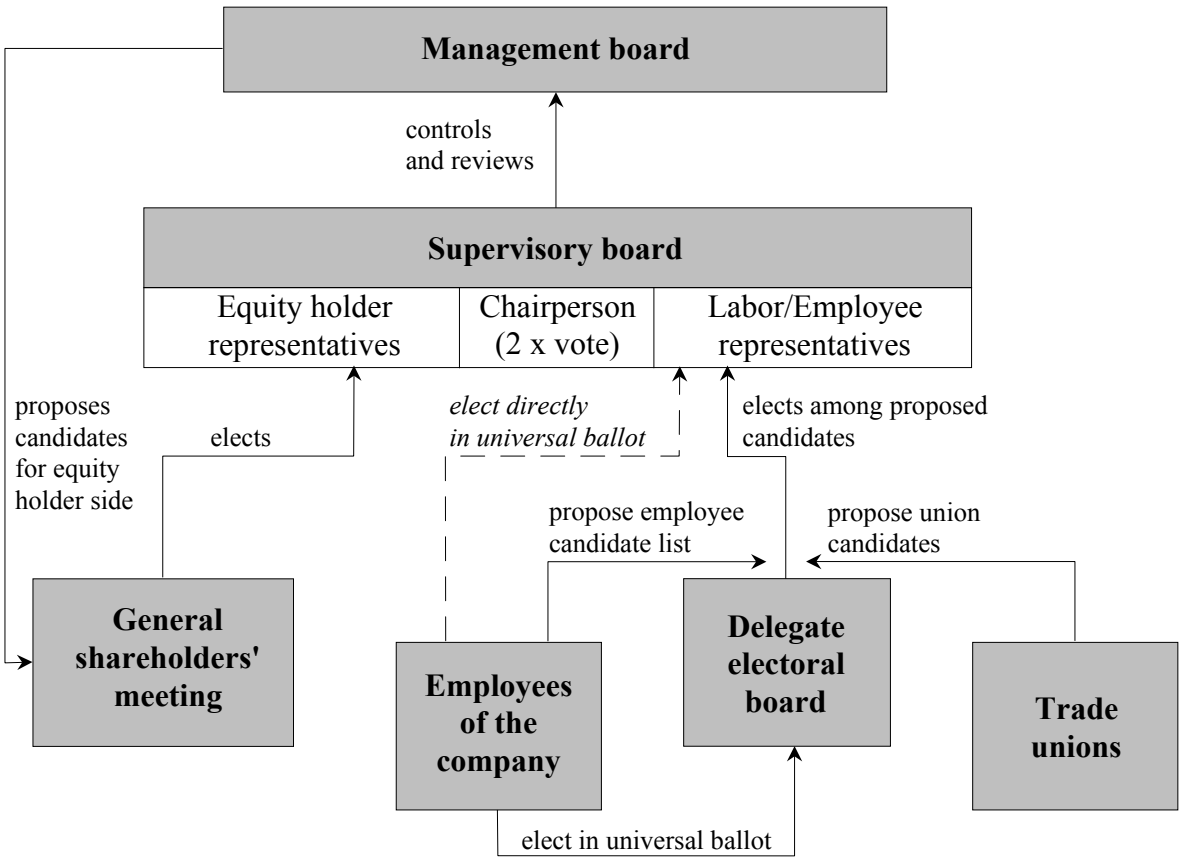
500 employees. Fifth, formal agreement of the workers' council is required in a number of important management decisions according to the law on the constitution of firms.

Rules of codetermination. Under the law of codetermination, introduced in 1976, employees are legally allocated control rights over all corporate decisions in the form of seats in the supervisory board. They have the same right as an owner of equity. The general idea is that the suppliers of capital and suppliers of labor steer the firm 'cooperatively'. Depending on the size of the firm, workers and trade unions can constitute either half or a third of the votes in the supervisory board of firms. In incorporated firms, i.e. in stock companies and in limited liability companies (*GmbHs*), with more than 2000 employees, half of the seats are allocated to the capital owners, the other half to the employees. In firms with less than 10 000 employees, there are six seats for both sides. One of the positions on the employees' side is earmarked for the managerial employees; two of six seats are reserved for the trade unions representatives who do not have to be employees at the respective firm. This regulation gives trade unions a foothold in the governance of firms entirely independent of the degree of organization (or lack thereof) among the company's employees. The number of seats increases with the size of the firm. In larger firms with ten seats for each side, i.e. in firms with more than 20 000 employees, the unions have three seats. The board members representing the equity holders are elected by the shareholders' meeting while the members of the board on the employee's side are elected by a conference of employee delegates or by direct ballot.[2] The employee representatives have to be employees of the company, with the

[2] In companies with up to 8 000 employees, the law prescribes the ballot, but employees may, by a majority vote, opt to be represented by delegates. In the case of enterprises with a workforce of more than 8 000, the law prescribes elections through delegates. The employees may, however, reverse this procedure, in other words, they can choose by a majority vote to have a direct ballot. If the board members of labor are chosen by delegates, there is a two-phase electoral process. In a first, universal vote, delegates (in general one per 90 employees) are elected among candidates that were backed by at least one tenth or 100 employees, these delegates in turn elect the employee and executive representatives on the supervisory board out of a list of candidates that were proposed by either one fifth or 100 employees.

exception of the trade union representatives. Trade unions have the right of nomination for their positions. Board members of labor can be recalled if a motion supported by three quarters of employees finds a three quarter majority among the delegates. The members of the supervisory board elect its chairman and the deputy chairman with a two thirds majority. If this majority is not attained, the representatives of the shareholders elect the chairman, and the representatives of the employees his deputy. At a parity of votes in decisions of the supervisory board, the chairman has two votes. In incorporated companies with less than 2000 and more than 500 employees, workers must make up a third of the member of the board according to Business Constitution Act.

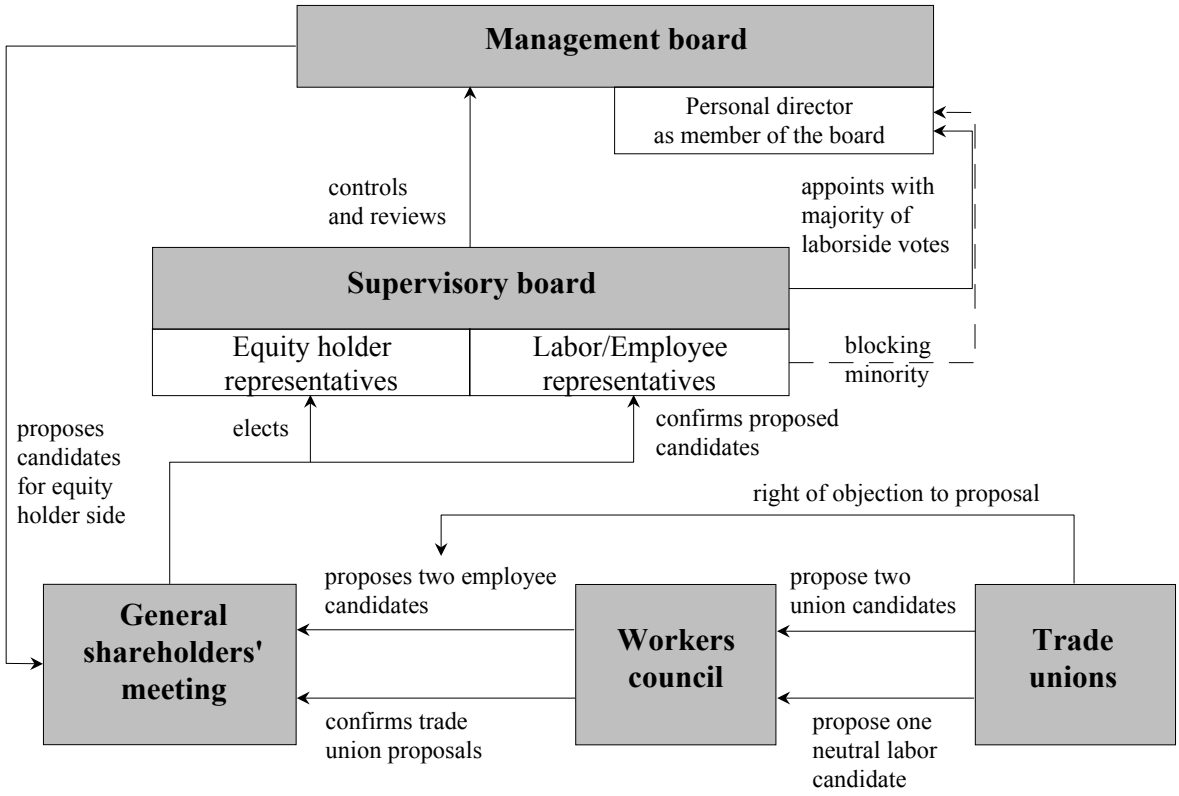
Figure 1: Codetermination in German firms



A specific law of codetermination applies to the coal and steel industry (Codetermination law of 1951, *Montanmitbestimmungsgesetz*) with a stricter form of participation. The threshold is lower than in the general law on codetermination; the law applies to companies with more than 1000 employees. The supervisory board consists of an equal number of shareholder and labour representatives along with a "neutral" member; it has eleven members (which in larger companies may be increased to 15 or 21). In the case of a supervisory board consisting of eleven members, five must be appointed by shareholders and five by employees. Two of the five seats for labor must actually be employees proposed by the workers' councils and two are proposed for election by the national organizations of trade unions represented in the company. The fifth member is also proposed by the unions but must neither be an employee or representative of trade unions or of the employers' associations nor have any economic interests in the company ("neutral man" on the side of labor). But even with respect to the employee members voted by the workers' councils the trade unions have the right to disapprove of any nominee who is unlikely to cooperate to the best of the company and the economy – a rather vague concept indeed. All labor representatives are first elected by the workers' council and proposed for election at the shareholders' meeting. The election is only a formality since the meeting cannot reject the nominees. Thus, the supervisory board is only free in choosing the five members of the capital side, among them a "neutral" person for the capital side. In the supervisory board of this industry, the chairman does not have two votes, but there is a third "neutral" member who is elected by the shareholders' meeting with the consent of both sides. In the event of a stalemate, this member of the supervisory board is the tie-breaker. The members of the management board are appointed and dismissed by the supervisory board. One of the members must be a personnel or labor director who cannot be appointed or dismissed against the wish of the majority of the workers' representatives on the supervisory board who have a blocking

minority. The labor directors are in a way the exponents of codetermination at the management level. Trade unions thus chose the person that ultimately is responsible for employment planning, lay-offs and wage-negotiations.

Figure 2: Co-Determination in the Coal and Steel Industry



Limited liability companies (*GmbHs*), which are not generally required by law to have a supervisory board, are obliged to establish such a board in order to introduce codetermination. For them, the same thresholds and majorities of codetermination apply, i.e. half of the seats for companies with more than 2000 employees and one third of the seats for companies between 2000 and 500 employees go to labor. In Germany, a formal division of corporations between stock corporations (*Aktiengesellschaften or AGs*) and private limited liability

companies (*Gesellschaften mit beschränkter Haftung or GmbHs*) exists. Both types of corporations are governed by different acts of German law, namely the Aktiengesetz (Stock Corporation Act) and the GmbH-Gesetz (Limited Liability Companies Act). This distinction has nothing to do with size, but rather refers to the ability of the shares of the company to be listed on the stock exchange. Only the shares of stock corporations can float on the exchange. There are currently around 700 000 limited liability (GmbH) companies, compared with only 15 271 stock corporations (2003)[3]. Of the latter, only about 1000 domestic companies are listed on the stock exchange[4], meaning that most stock corporations are also privately held. If it were not for the rules of codetermination, limited liability companies would be free to determine in the partners' contract whether they want to have a supervisory board. If they choose to have one, the same rules apply as for stock companies. If they do not have one, the owners' meeting is the controlling body to which management, often one or two of the owners, has to report.

Codetermination and the firm as an implicit contract. How codetermination affects the decisions of firms and their performance in an international comparison is a heavily debated issue. This issue is additional to the question on how the German two-tier system fairs relative to the Anglo-Saxon system of corporate governance.

It can be argued that the advantage of this system of codetermination is the cooperation between different groups of a company so that the interests of the employees, of the shareholders and the firm are considered when important decisions are made. It is a kind of "stakeholder value" concept that attempts to lessen conflict potential by institutionalizing consultation and cooperative

[3] 3 780 in 1995, 7 375 in 1999. Data according to Bundesbank, Monthly Report January 2004.
[4] Deutsche Börse for December, 2002.

decision-making. This is expected to ensure, in addition to the participation of the workers' council, a positive motivation of the employees, and this is seen in turn as beneficial for the performance of a company. Of course, people dislike hierarchies, and in the American approach the aspirations and fears of the company's employees tend to be anticipated by the management in an informal way. After all, the reputation of a company is important in attracting qualified employees, and consequently, its market value in the financial community hinges on the motivation of its employees.

A firm can be understood to be an implicit contract between the factors of production defining which factor carries which risk and which factor receives which expected remuneration under unknown states of the world. Traditionally, this contract is understood to guarantee a secure income for labor, an important input provided to the firm, with capital taking on the income risk. Income to labor is guaranteed only under the assumption that the firm continues to be economically viable so that labor also carries the employment risk, reduced by the legal setting; capital carries the risk of bankruptcy. With codetermination, employees can influence how this implicit contract is written *de facto* and how income is distributed among the factors within the firm. If codetermination sufficiently empowers employees, and if stockholders' rights cannot be contractually protected, then employees are able to change the risk allocation redistributing the firm's surplus towards themselves, thus increasing the *ex ante* uncertainty for capital owners. They then alter the nature of the firm. In addition, if employer interests are not contractually protected, then employees are able to choose a different objective function for the firm, including a higher reward for labor and more job guarantees. Thus, codetermination is about the allocation of risk and the very nature of the capitalist firm. It also is about the allocation of power over the distribution of income and employment opportunities under unknown states of the firm's environment and determines the weight of

shareholders versus that of stakeholders in these basic issues. Both sides are likely to have different preferences on these points, especially with respect to securing jobs.

It is argued by some that under the existing rules of codetermination, final decisions always lie in the hands of the shareholders and that consequently codetermination does not make too much of a difference for the decisions of a company. This is not correct. In such an institutional set-up, one normally likes to have the consensus of all the groups involved. Thus, if the representatives of the employees will not vote for the chairman of the management board, the capital side is likely not to insist on its candidate or the candidate himself will withdraw in sight of the lacking support of the employees as happened in the election of the last chairman of BMW in 1999. Decisions thus tend to be politicized. There is no question that this institutional set-up significantly influences corporate decisions.

In the context of motivation and the allocation of power, a distinction should be made between the employees and trade unions. Viewing codetermination as an instrument used to improve the relationship between management and its employees, the question of whether this is an appropriate approach can be raised, especially in the presence of outside unionists. Furthermore, it is actually in the self-interest of management and the share-holders to take into account the interest of the firm's employees. Despite this, however, there clearly are cases when the views of shareholders and employees diverge, for instance when a plant is to be closed.

For trade unions, codetermination is an important source of power; it increases their political leverage and also provides positions for their members, especially their leaders. Consequently, they have a strong interest in preserving

codetermination. However, there is a clear conflict of interest between the role as a trade union leader and as a member of the supervisory board. For a member of the board, the obligation is to promote and to protect the interest of the firm, whereas for a trade union leader the aim is to promote the interest of the union. The possibility of having to call a strike against the firm exists in this case; in principle, the firm would have the option to close out workers. This conflict became apparent in early 2003 when the leader of the service sector union Verdi, Birske, a member of the supervisory board of Lufthansa and its vice chairman, called a strike against this very firm. This conflict of interest exists independently of whether the trade union members of the board pass on their remuneration largely to the trade unions' foundation.

Workers' Councils

The workers' council has a set of decision rights where its consent is mandatory according to the Business Constitution Act (*Betriebsverfassungsgesetz*). These rights of codetermination (*Mitbestimmung*) effectively limit management's directive powers, demanding the approval of either the council or a successful mediation for decisions to become effective. In addition, the law establishes the right of collaboration in decision making (*Mitwirkung*), requiring that the workers' council must be heard on the relevant issues; failure to do so may result in the invalidity of a decision taken by management. Furthermore, there informative and consultative rights and the right of autonomous administration of all workers' council affairs (Niedenhoff 2000).

The rights of codetermination apply to decisions of special interest to the employees, especially the conditions of work and the workplace in a business. This includes the organization of the work process, for instance group work, the arrangement of working hours in a plant per day, the length and lay-out of work

shifts, the design for working time on the weekend and overtime, unless specified by a collective contract with the unions. Codetermination also extends to vacation plans, ergonomic standards, special company benefits such as housing or day-care, remuneration schemes and means to measure and supervise the efficiency and performance of the employees - these include for instance agreements with superiors on individual annual objectives, performance-based remuneration schemes, and process performance measurement such as activity-based costing - and team-based arrangements of workflows. Agreement is needed on measures when employees lose their qualifications due to the introduction of new production processes. The workers' council also approves the hiring of new personal staff planning, pertaining to the assignment of new responsibilities and company-internal transfers. The workers' council can thus effectively block the promotion of an employee if it believes, for example, that the pay-rise involved unduly favors this employee over others. Its consent is required for lay-offs and for social closing plans. In the case of regular layoffs, the workers' council can disapprove of the decision based on certain criteria (employer did not screen for social aspects in selecting employee to lay off, or continued employment would be possible given certain adjustments); this disapproval by the council gives the employee the right to sue for continued employment, delaying his dismissal until a final court ruling.

General tasks of the workers' council extend to supervising the compliance with collective bargaining results and legal stipulations in the company, among them workplace safety and environmental regulations, promoting equal rights among the workforce, as well as helping to foster and secure the conditions for employment. On all these issues, management and the workers' council who meet at least once a month, are called upon by law to cooperate in an atmosphere of confidence, looking for solutions in the best interest of the company and its employees; accordingly the workers' council as an institution

may not take part in hostile activities of collective action. Agreement of the workers' council is not explicitly needed in strictly entrepreneurial decisions, including investment and financing, product development, marketing and public relations.

The workers' councils decisions are binding for all employees[5]. By joining a firm, an employee automatically renounces on individual rights in defining his or her labor contract. The workers' council members are elected; they are not necessarily representatives of the trade unions although the unions play a dominant role. By law, employees have the right to establish a workers' council for each business of a firm and for the firm as a whole. Business here refers to the organizational unit, i. e. the *Betrieb*, not being identical to the legal unit of the firm nor the technical unit of a plant. The right to establish a workers' council refers to businesses with at least five regular employees. A council is established by election of its members through the employees. Where employees do not care to vote, firms are without a workers' councils. As a matter of fact, many smaller firms do not have a workers' council. According to a survey of small and medium-sized German enterprises, only 4 per cent of firms with five to twenty employees had a workers' council in 1999. In firms with 21 to 50 employees it was 16 percent and in firms with 51 to 500 employees 67 percent. In contrast, nearly all firms with more than 1 000 employees had a workers' council (Wassermann 2002: 165). According to information from the trade unions, the average voter turnout in firms already having a worker's council was about 72 per cent in 1998.

The workers' council's size varies with the number of employees. For instance, in firms with 51 to 100 employees, the workers' council has to have five

[5] Unless they represent recommendations for the individual labor contract (Regelungsabreden).

members.[6] The members of the councils are to be set free from their work to the degree that their responsibilities in the workers' council demand it while continuing to receive their regular pay, and in addition have a general right to three weeks of educational leave per year. Starting at 200 employees, some council members (usually starting with the chairperson) have to be entirely relieved of their regular work tasks to dedicate their full time to the workers' council; from 10 001 employees on, the number of full-leave council representatives is 12 and rises by one for every additional 2 000 employees. During their time in office and for an additional year after leaving the workers' council, any member enjoys far-ranging protection against layoff. If the workers' council has nine or more members (i.e. in firms with at least 201 employees) it elects an executive committee to take care of daily business. For firms with over 100 employees, a business committee of three to seven members must be selected at the level of the entire company; only one member has to be on the workers' council. This committee has far-ranging rights to be informed and consulted once a month by the company's management on current business matters such as investment projects, sales numbers or rationalisation efforts. As the various layers of the company's organizational structure cause different issues to arise, the individual workers' councils usually send representatives to form a council at the company and if applicable at the group or holding levels (*Gesamtbetriebsrat* and *Konzernbetriebsrat*). Among those different layers of councils the principle of subsidiarity prevails rather than a hierarchical structure. For firms that have at least five employees who are below 18 years of age or are apprentices and younger than 25 years, a separate youth and apprentices' council is elected that has an advisory role to the workers' council on issues pertaining e.g. to apprenticeship or protective rights of minors. The law also calls for the gender that is in the minority among the company's personnel to be represented

[6] The council consists of one representative for businesses with five to twenty employees. For firms with more than 9 000 employees, two additional representatives are added for every additional 3 000 employees until a maximum number of 35 is reached. .

on the council in a number at least proportional to its share among employees. It goes without saying that all costs of the workers' council are borne by the firm.

Similar rights hold for the personnel council in the public sector including the universities and research institutes.

The workers' council represents an institution that helps to standardize rules in firms and also allows to discuss conflicts and bring about consensus. At the same time, the institutional set-up assigns decisions rights and thus power to an elected body, taking it away from individual employees and the management and the owner of a firm. It allows participation of employees and trade unions, but put restraints on the management of firms. If things go smoothly, this institutional arrangement reduces transaction costs. If, however, the issues roughen and if fronts between the two sides harden, transaction costs may actually be increased. For instance, the workers' council may use its power to refuse its consent to a management proposal if it does not get one of his projects through in return. This deal-making may imply economically inefficient solutions. The whole procedure is a time-consuming process. What is more important: A workers' council requires quite a bit of attention and also of energy. In larger firms, in which the personnel director manages the ongoing relationship with the workers' council, this normally does not tend to represent a problem. In smaller and medium-sized firms, however, which crucially depend on the energy of the owner-entrepreneur, the attention required by the workers' council eats up part of the available entrepreneurial energy that then no longer is available for innovation, marketing and strategic positioning of the firm.

The Red-Green government has extended the Business Constitution Act in several ways in 2001, following the pressure of the trade unions. The threshold for the chairman of the workers' council to be released from work has been

reduced from 300 to 200 employees. Additional procedures to establish a council in smaller firms have been introduced. This means an extension of codetermination to the small firms, where the role of the owner-entrepreneurs or family management is particularly prevalent. As no quorum is set for electing the workers' council, well-organized groups may use the workers' council to hijack it for special interest purposes. The law has also been changed by giving the workers' council more rights, one of them being the obligation that the proposals and opinions of the workers' council have to be considered by management; during the time of consideration, no decisions can be taken on these matters. The new law also contains additional requirements on environmental protection in the firms, equal opportunity of women and the discrimination of foreigners in firms. One of the major articles of the law, paragraph 77 sec III, preventing a deviation from the collective contract even if there is agreement in the firm, however, was not changed. To sum up, the law has made decisions processes more complicated and has strengthened the position of the trade unions in an economic situation in which Germany went into stagnation and in which more flexibility would have been required.

The Future of Codetermination

Impact on the decision making within firms. With codetermination defining the weights of the shareholders and of the employees and furthermore with the workers' councils as an institution to voice the interest of employees, it is held within the economics literature that the German system, particularly when also taking into account the role of banks and block holders, has proved to be less able than the Anglo-Saxon system to make decisions quickly (Holmstrom 1999, Hopt 1999, Mayer 1998). This general disadvantage of the German system is further aggravated by the institutions of codetermination and the workers' councils. It is fair to say that in the end structural change and plant closings were

not prohibited by Germany's institutional approach.[7] If people had to be laid off, this was done predominantly via the combination of social closing plans and governmental programs of early retirement solving labor market issues at the cost of the pension system. Together with the rigidity of wages, however, the adjustment of the German industry did not consist in the creation of any new jobs. Relative to structural change, codetermination can be seen as a defensive instrument. Looking at it in a long-run view, it protected the insiders, at least temporarily; such a protection always comes at the disadvantage of the outsiders.

Besides sector adjustment, another issue is innovation. In this respect, codetermination and the workers' councils seem to be appropriate in finding a consensus along the firm's established technological trajectories, marginally improving the existing production technology and modernizing established products. These approaches are, however, less apt in an environment where a new technology has to be applied and where new products have to be developed and when leapfrogging to a new technology is the key task. These more radical changes, often viewed with suspicion as job-killers, conflict with the structurally conservative mindset epitomized by the institutions of codetermination.

Both forms of participations of employees negatively influence the attractiveness of Germany as a location for investors from abroad. Moreover, they affect the locational advantage when domestic investors look at options in other countries. This argument deserves more weight with the increased international mobility of capital and technology. A smaller capital inflow or even a capital outflow as a consequence of these forms of participation mean that less capital would be accumulated in Germany and fewer new technologies might be attracted so that the German employee will be equipped with capital

[7] For instance, when Krupp had to close its steel plant in Rheinhausen under severe public and workers' protest in 1993, it could do so with the vote of the "neutral man" in the supervisory board.

less generously, reducing his productivity and his wage earning potential. In addition, codetermination according to the German set-up leads to a lower international evaluation of companies incorporated as joint stock companies. This would mean that Germany becomes unattractive for holding companies.

Historically, raising issues of codetermination in public has virtually been a taboo, chairmen of the boards usually stressed that these institutional approaches were a good thing and that they personally were getting along very well with their partners in the supervisory boards and the workers' council. Meanwhile, one can hear statements questioning the concept of codetermination, especially in light of the necessity to respond swiftly to a changed economic environment and therefore to quickly reach decisions. In any case, besides the aspect of providing power to the trade unions, it is now recognized that there is a trade-off with respect to codetermination: it is an instrument bringing about coherence of the firm, even partly allowing the implicit contract between the factors of production within the firm to be self-enforcing and sustainable, but at the same time delaying decisions, slowing down innovation in focusing the interest on marginal improvements of a given trajectory and making Germany less attractive as a location for international investment. In a way, we meet again the basic conflict of the German approach, the dichotomy between coherence, social considerations and equity on the one hand and dynamics and efficiency on the other.

A changing international environment. I have already discussed the advantages and the disadvantages of the two-tier board system versus the unitary board system in another working paper and have suggested that the market will tell which of the two systems will prove to be viable in the future. In answering this question, an important aspect is that the international conditions, in which the German system of governance, including codetermination, is embedded and by

which it is affected, are changing. In the banking industry, market products are developing due to internationalization and disintermediation along with the pressure on banks by their clients to facilitate their access to capital markets. The shareholder structure is becoming more international due to globalization and the diversification of large, institutional and actively managed portfolios, making block holding less likely. “Shareholder activism”, increasingly exercised by institutional investors, should work towards more profitability- oriented and value-oriented corporate policies. The establishment of investor-relations departments in most German exchange-listed companies evidences this trend. Block holding will also be pushed back by new regulations of the European Union referring to the take-over of enterprises. Banks, insurance companies and corporations no longer have an implicit incentive to maintain holdings, since they can sell their shares without paying any capital gains taxes on the sale of these investments. All in all, these international developments in the market for corporate control will leave their mark on Germany. This is likely to have an impact on the role of codetermination in German corporate control.

But in addition, the German system of codetermination becomes incongruous with internationalization of German firms (Baums 2003). Foreign employees of German firms do not participate in the election of the workers’ representatives in the supervisory board, nor are their trade unions represented. Since larger German firms meanwhile have half of their employees abroad, the legal stipulations of the codetermination law of the 1970s now appear as an attempt to secure representation and voting power to the German employees. It can be interpreted as an institutional arrangement in favor of a specific group of insiders. Such arrangements are an instrument to guarantee income and even rents to those employed and to members of the unions. This inconsistency between the desire to secure the position of German employees and the reality of world-wide employment in German firms cannot be overcome by a world-wide

approach to codetermination along the German lines. On the contrary, the issue is that the actual system does not seem to be tenable under conditions of globalization.

Moreover, in the European Union the principle of non-discrimination of EU citizens prevents the continuation of the German arrangement as it now stands. To extend the German approach of codetermination to the other member states of the European Union, for instance by having EU-wide regulations, would rightly meet the opposition of the other EU members, which have a different institutional practise with their own historic experience and which also have their own preferences. Moreover, the concept of institutional competition and the EU's principle of mutual recognition of national institutional set-ups prevent such a harmonization. In this spirit, the European Court of Justice has allowed firms from other EU countries with a different form of incorporation and without codetermination to operate in Germany. This ruling from November 2002 has generated interest among German companies to move their legal headquarters into a neighboring country, evading codetermination while continuing their operations in Germany as before. Codetermination thus joins tax optimization as an important rationale for corporate relocation. Aventis' selection of Strasbourg as new headquarters reflects this just as well as EADS' decision to take its legal seat in the Netherlands.

Rules for take over. Together with all aspects influencing the attractiveness of a company for an international investor such as taxation and the rules for codetermination as well as for the workers' councils, explicit conditions for mergers and acquisitions define an important aspect of corporate control. While take-over activity has increased in the 1990s and recently, Germany continues to have a relatively low level of take-over proceedings. Thus, only two per cent of the transaction volume of announced hostile world-wide corporate takeovers in

the period 1990-1998 involves German companies as targets in contrast to 89 per cent to the Anglo-Saxon companies and 6.4 per cent to French and 1.3 to Scandinavian firms.[8] As a matter of fact, takeover activity and hostile bids were so rare that Germany had no law for take-overs, but merely a voluntary take-over code that very few listed companies submitted to. It was only in 2002 that Germany introduced its first ever takeover code, setting ground rules for companies and investors alike. The new law regulates all public offers to acquire certain market-traded equity securities of German domestic companies, whether for stock, cash or a combination thereof with additional provisions to apply where the acquisition or holdings exceed a defined threshold. When the new German Takeover Act replaced the voluntary Takeover Code, the 'squeeze-out' of minority shareholders in a stock corporation, at the request of a majority shareholder (holding at least 95 per cent of the issued shares), was permitted. Since the expulsion of minority shareholders can now be accomplished in a relatively straight-forward process instead of a risky multi-step transaction, many investors viewed the new rules as the single most important improvement in German corporate laws in recent years. This new law also sets the reporting requirements, the criteria for the offer-bid, the duration of the offer period and the conditions under which the takeover law applies to all public offers where the target is a German-based stock corporation or limited partnership by shares (*Kommanditgesellschaft auf Aktien*), whose stock is publicly traded on an "organized market" in Germany or anywhere within the European Economic Area. It gives management some instruments of defense.

Similar to the golden shares of the French state in former state-owned firms, Germany knows a specific regulation, the so-called VW Law, that effectively protects the car maker Volkswagen from a hostile takeover. Lower Saxony's government owns just under 20 per cent of VW's shares, and a special regulation

[8] The proportions of acquirers are similar. Data from Guillen (2002), quoted in Van den Berghe (2002: 68).

prevents any other shareholder from controlling more than 20 per cent of the company's voting rights. Accordingly, when he was governor of the federal state of Lower Saxony, Gerhard Schröder had a seat on the VW supervisory board. This regulation makes Volkswagen the only German company to enjoy a similar kind of protection as a golden share. In a landmark ruling of 2003, the European Court of Justice effectively banned the use of golden shares. This will put into question other ways in which governments within Europe have secured themselves the right to intervene in the takeover process including the VW law.

In order to foster corporate restructuring and capital market integration, the European Commission has repeatedly attempted in the last fifteen years to introduce a EU-wide takeover regulation, but has encountered strong resistance. A compromise was finally reached in late 2003, aiming to boost the power of shareholders and limit the rights of European companies to protect themselves from takeovers. The initial goal in crafting the continent-wide policy was to make merger and acquisition activity a more brisk process than previously. The German government, however, worried that such an outcome would spark a wave of hostile takeovers on German flagship companies (e. g. VW), a view that was echoed by the Nordic countries (especially Sweden concerned over Ericsson). Despite these efforts to protect their corporations from takeover bids which were opposed by other EU members, such as the United Kingdom, Germany and the other countries with similar preferences were successful in winning their agreement by making concessions in other areas, for example bans on “poison pills”, which would made hostile takeovers prohibitively complicated or expensive, as well as on multiple voting rights, which would have allowed some shareholders to control a company without holding a majority share.[9] In exchange for backing Germany, the United Kingdom

[9] Often there is a differentiation into type A (voting right) shares, for instance tightly held by the founding family, and type B shares, limited to the right to participate in dividend payments.

received reciprocal support in blocking commission rules on employment rights for temporary workers.

The Governance of the Universities

The university system with nearly 2 million students in the winter semester 2002/03 and an annual budget of 28.6 bill euro for public and private universities in 2001 is organized as a governmental system under the responsibility of the states. It is financed from tax revenue except for several private universities already existing and few ones that now come into being at the educations sectors' fringe. The funds are allocated by the parliaments of the federal states. The governance system is one of administrative planning in which the respective ministry of culture of the federal state is in charge of administering the university in many respects more or less directly. Recently, the ministries of several states have attempted to write contracts with the universities defining the universities' targets and providing funds for a planning period and thus granting the universities more autonomy. These principal-agents contracts are reminiscent of a central agency like GOSPLAN in the former Soviet Union writing such a contract with the firms. As a positive step, in quite a few cases a board of regents is now introduced, endowed with the authority to decide some of the issues that were dealt with by the ministries so far.

As the universities are public, each student who has obtained his high school diploma (*Abitur*) has a right of access. Student fees are a taboo; formal agreements among the federal states regulate that universities are not allowed to take fees from their students. [10] Where student slots are scarce, a nation-wide allocation mechanism has been introduced that allocates the scarce slots to the student candidates in a lengthy process, in which the interest of universities in

[10] Several states have now announced to terminate this agreement.

obtaining motivated and qualified students does not play a role. Thus, a bureaucratic procedure is relevant for the access to the university. As of now, student tuition fees are prohibited for any student's first degree studies by the Federal Framework Act for Universities (*Hochschulrahmengesetz* § 24 Sect 4) so that scarcity of students slots cannot be dealt with by a price mechanism. Some federal states now introduce extremely modest student fees of (500 or 1000) euro for those students who study a second discipline after having received a degree in another discipline or who study longer than the standard length of the study requires. But even these modest fees are not politically accepted by the students; they view the free access to the university as a fundamental entitlement, for whose implementation society has to bear the costs. Some federal states now are granting the universities the right to choose and recruit a part of their students themselves, but the Federal Framework Act for Universities puts strict limits on the criteria that can be applied, and whenever capacity is limited, the national allocation mechanism precedes any selection at the university level.

An implicit aspect of the German university system is social justice, but target has not been reached. Politics did not succeed to open up the system to the lower strata of society. Ironically, since the working class contributes a large proportion of taxes that go into the financing of the universities, the middle income groups get the education of their children for free; comparing benefits and costs for the different groups, the middle income groups benefit more from free access than the working population. Thus, the system is not really socially just. Moreover, it is not competitive internationally.

The approach of administrative planning used for German universities does not rely on the force of competition. Universities do not select their students, and students can select their universities only within limits. Except for the intrinsic

behavior of individual professors, universities and their departments are really not in competition with each other. Thus, competitive pressure is not used as a controlling device for German universities. They also cannot enjoy the options that competition entails. Not being able to set fees, they cannot raise money for their operation and for investment. For instance, they cannot cater to the international market for undergraduate and graduate degrees and skim off the internationally given willingness-to-pay with receipts that could be used for investment. Germany has neither have the imagination nor the courage to expose this segment of society to competition. Looking at the this history and at the strong position of the Social Democrats to strictly oppose student fees, it is amazing that as of January 2004, the party now favors "elite universities".

Other Institutional Set-Ups of Group Decision-Making

As has been illustrated so far, the German system of governance delegates decisions to groups and decision bodies. This is typical for many areas: for the role of the social partners in the labor market with decisions on the wage level, the wage structure and important aspects relevant for employment; for the banking industry with its intermediated products; for the decision-making in firms with codetermination in the boards of larger firms as well as with the participation of the workers' councils; and for codetermination in the universities. This consensus or corporatist approach places no trust in competition. The agreement of many groups of society is sought when policy measures are taken instead of letting decisions emerge from the many individuals and instead of relying on the market as a mechanism of allocating incentives and as a method of control.

There are other important areas of society governed by self-administration, i.e. by the German approach of group-based decision-making which relies on

consensus-inducing mechanisms of the institutional structure. One example would be the associations of statuary health insurance physicians in the public health system (*Kassenärztliche Vereinigungen*). These organizations represent the physicians whose patients, about 90 per cent of the population, are covered by the public insurers. These physicians are required by law to be members of the organization. According to the social law[11], the role of these organizations is to negotiate the physicians fees with the public health insurers. These organizations may be seen as the physicians trade union, however with mandatory membership. Although they can be interpreted as a countervailing power to the public health insurers, this approach establishes at the same time a bargaining cartel that develops its own interest. Thus, individual public insurers are forbidden to negotiate their fees directly with specific physicians and hospitals so that an integrated health management system, which can be found in Switzerland and in the United States, is legally prevented. In such an integrated system, insurers offer their own medical services through a network of physicians and hospitals at a reduced insurance rate. In this way, competition between public insurers can be initiated.

The associations of statuary health insurance physicians in the public health system have the additional task of making sure that sufficient medical services are provided throughout the country, including the country-side[12]. They also limit the number of doctors in any field of specialization in areas moving towards an "excess supply" of certain physicians, such as inner- city locations. In this area, then, an implicit distrust of market forces becomes evident – market failure is assumed a priori. Rather than applying countermeasures, such as monetary incentives for doctors to locate in rural areas with fewer medical services, an institutional planning system is set up for the entire economic

[11] SozialGesetzBuch V § 82.
[12] SozialGesetzBuch V § 99.

activity conferring decision-making power to organized professional groups. The patients, by the way, for whose benefit this system is supposedly set up in the first place, remain without representation.

Other areas in which decision-making is allocated to groups are the chambers of agriculture, chambers of commerce, chambers of craftsmen, chambers of architects and regional bar associations, all with mandatory membership. These organizations represent part of self-administration in Germany, dealing with issues of a common interest for those organized. This includes, for instance, administering the apprenticeship system and standardizing apprenticeship profiles and the examinations for these profiles by the chambers of commerce and craftsmen. While a case can be made for self-administration in these areas, because problems are solved in a decentralized way according to the subsidiarity principle, these approaches also drive out market solutions. For example, the fees architects and lawyers can charge are strictly regulated, and advertising is prohibited for them just as for other professions such as physicians, dentists or pharmacists (all forming part of *Freie Berufe*) who are considered a sphere where competition is not desired. Chambers of craftsmen also may be considered an instrument of colluding on prices and controlling the access to the market by administering the exams to be a master craftsman. All chambers publicly express the joint interest of their constituents, participating as lobby groups in the political process. They represent interest groups, which get support from the state for their organization by the device of mandatory membership and the transferral of exclusive norm-setting privileges, exempting their respective sectors from the rule of market forces.

Organized groups also are involved in self-administering important aspects of economic life in Germany's public sphere, including the social security systems. In 174 supervisory boards of the federal government, interest groups are

overwhelmingly represented (Rudzio 2003:104). Thus, representatives of interest groups have a seat in the supervisory boards of the Kreditanstalt für Wiederaufbau, the agricultural import and stock agencies as well as the radio and television stations. Trade unions and employers' associations nominate the assessors for the labor and the social courts. The public welfare organizations (*Wohlfahrtsverbände*) – the Red Cross, Workers' Welfare (*Arbeiterwohlfahrt*), Caritas (of the Catholic Church) and Diakonie (of the Protestant Church) - actually implement the laws of social welfare and youth welfare, for instance by running kindergartens, nursing homes and hospitals.[13]

An often found form of representation of organized groups is the one-third parity where one third of the seats in a supervisory board goes to the trade unions, one third to the employers' associations and one third to government. Thus, the Labor Office (*Bundesagentur für Arbeit*) is supervised by a board in which the social partners have two-thirds of the votes; the remaining one third of the votes goes to different layers of the government, i.e. the Bund and the states. As of 2004, a new set-up applies to the Labor Office as part of the 2003 reforms. Whereas the Office used to be a governmental agency under the direction of the Economics and Labor Minister, with more of a counseling function of the supervisory board, it now will be steered and controlled by the supervisory council. Although this new arrangement may be seen as an attempt to decentralize decisions and to no longer have them taken by the respective ministry, it assigns additional power to the trade unions and the employers' associations. In a way, they now can more directly influence unemployment policy and thus control the policy that is needed due to the failure of their own behavior in wage-setting. They have control over instruments that allow them to shift the impact of their behavior to a third party, the state and the taxpayer. In

[13] All four organizations have 1 125 000 full-time and part-time employees (data for 1995/96 Rudzio 2003:104). It is questioned whether this service sector is sufficiently controlled and whether its efficiency can be substantially increased.

January 2004, they used this new power to oust Florian Gerster from his position as head of the management board of the Labor Office; he had pushed for reforms and had only been installed two years earlier by Schröder to modernize the Labor Office. His line of policy fell victim to the opposition of the unions.

Also other institutions of the German social security network are self-administered in a manner that gives trade unions and other continuously organized interest groups a significant say. In both the pension system and the public health insurers, social elections (*Sozialwahlen*) are held every six years among all current contribution-paying insured and pensioners to elect the supervisory council (*Verwaltungsrat*) in the health insurers and the assembly of representatives (*Vertreterversammlung*) in the pension system. These supervisory bodies are made up to an equal share (30 members each), by the two groups that pay the contributions: the insured and their employers.[14] While the employers' associations determine their representatives independently, all insured persons and the pensioners can elect representatives from candidate lists, for which the right of proposal is restricted to employee associations with social policy objectives (mainly voluntary interest associations of insured) and the trade unions. However, as the participation in these elections is rather meager (in 1999 of the more than 32 million insured and pensioners of the largest public pension institution just above 10 million voted), the chances of motivated minorities to gain over-proportional representation are high.[15] These bodies have stark prerogatives similar to those of a parliament, they elect the board of directors (*Vorstand*) and a separate management board (*Geschäftsführung*), decide on the annual budget, have to approve the annual report and have the power to set and change the autonomous statutes of the institution. They, just as

[14] Only in those statutory health insurers that have their origin in self-help associations of professional groups (*Ersatzkassen*) there are no employers' representatives.

[15] In the largest public pension insurer (*Bundesversicherungsanstalt für Angestellte*), eight of 30 members in the assembly of delegates are trade union representatives, and one is a representative of social organizations of the Catholic and Protestant Churches. The head of the board of directors also is a trade union representative.

the board of directors, have two chairpersons who alternate yearly, one from the employers' representatives and another from the representatives of the insured. While day-to-day operations are taken on by the management board, the board of directors administers the institution's funds, decides on construction projects and extraordinary personnel and organizational issues, sets up the budget and represents the institution. Members of the supervisory bodies and the board of directors are unsalaried but have their expenses paid.

It is without any doubt, that these institutional arrangements endow the organized groups with additional power as they not only have a role in overseeing the key institutions of Germany's social security system, but they also represent these institutions in the public sphere and the political process. They thus have the power to voice the structurally conservative interests of their groups via the megaphone of public institutions. It may occur, then, that in the committee-approach to reform proposals that is currently preferred by the Schröder administration, they have several seats at the same table: one in their original function as interest group and another one in the guise of representatives of public social security institutions.

Other examples for decision-making by groups are voluntary sector agreements that have been used in bringing down sector emissions in environmental policy. The attempt to open up access to power and gas lines by voluntary sector associations is yet another case in point; it failed so that a new regulatory regime had to be introduced.

The Consenus Approach

In addition to these formalized institutional approaches of group decision-making, as written into law, more informal attempts to find a consensus have

been tried as well. These were the “concerted action” between the relevant social groups, especially the trade unions and the employers’ association by the economics minister Schiller in the 1960s and Chancellor Schröder’s round tables representing different groups of society. An example was the “Alliance for Work”, a forum including the trade unions, the employers’ association, German industry and the German Chamber of Commerce, in which Schröder tried to reach some consensus in the years 1998-2000 on important questions concerning unemployment. This attempt quickly failed. The main reason was that unions were not willing to discuss the issue of wage-setting. Another example has been committees such as the “Hartz Commission” and the “Rürup Commission”, who were created to develop blue-prints for major reform steps and to secure the consent of the groups represented in these committees.

An implication of this approach is that the decisions taken reflect the interest of organized groups and of the incumbents. Organized interest groups are endowed with bargaining power; they get a de facto veto right. Consequently, major changes are not accepted when important groups of society are negatively affected by them. For instance, the trade unions have so far blocked important modifications in the system of rules and regulations for the labor market. Or, as another case in point, the Riester reform of the pay-as-you-go pension system was only possible after the unions agreed in December 2000 on the pension formula. In a way, the consensus approach is an application of the Pareto criterion according to which an increase in welfare presupposes that at least one wins and no one loses. This problem, however, is that in a corporatist setting and in a static perspective a relative improvement for one group is considered a loss for the other groups. This prevailing mood becomes even more severe in a situation in which all groups must cut back their social absorption. The consensus approach implies that the status quo plays a central role and development becomes extremely path-dependent. This is not an institutional

environment which is conducive to leapfrogging. Consensus translates into risk aversion. A standstill is the most likely outcome, and economic dynamics are lost. Decisions tend to be blocked if you look for consensus on all sides, effectively handing out veto rights to groups with a vested interest in the status quo.

The consensus approach may have been appropriate in an environment of high GDP growth rates of 8 per cent as in the 1950s, and over 4 per cent in the 1960s when the German economy was catching up to the Unites States and welfare gains could be spread widely. In a situation, when the growth path is characterized by a growth rate of only about 1½ percent, as in the last eight years, restraints become more binding, goal conflicts more biting and flexible responses less likely. Negative external shocks then are hard to come by. This suggests that the institutional set-up for decision-making is part of the German problem of low growth performance.

A serious shortcoming is that such an approach does not make use of decentralized allocation through markets and competition in which changes occur more or less automatically and where market participants are expected to adjust to new economic conditions. Round-tables do not have an automatic and decentralized way of finding new technological and organizational solutions. They are concerned with formally establishing and adjusting the rules. Such a system does not make use of the problem solving capacity of decentralized markets and of competition. Creative energy is lost, because the problem-solving potential of the market and decentralized competition is not exploited. What needs to be avoided, in conclusion, is to empower interest groups by handing them the bargaining power over changes in the status quo as this institutionalizes obstacles to an evolutionary process of economic and social change given the conservative incentive structure of these incumbents.

Adhockery in the Government's Approach

The consensus approach in a corporatist setting means that government can take discretionary decisions. A politician who can focus such decisions into popular issues that make the head lines in the press can use this approach to put himself into the limelight. The politician is like a fire fighter. If a fire breaks out, he can come to the rescue. If there is problem, he will step in and solve it. If a firm is threatened by a crisis, such as one of illiquidity or even insolvency, he will come and help. He proves his indispensability to society. This activist approach is made easier in an environment in which corporatist decision-making is the rule. Thus, the corporatist approach leads to interventionism, to adhockery and to a short-run orientation. "In the long run, there is just another short run" as Abba Lerner once said. More fundamental restraints are likely to be put on the back burner, for instance long-run impacts of economic policy measures, issues of sustainability and intergenerational budget constraints. In such an approach, the politician does not lead in the true sense of the word and he is not a statesman. As Churchill answered when asked what makes the difference between a politician and a statesman: „A politician always thinks of the next election, a statesman considers the next generation". During his first term, Chancellor Schröder used this short-run approach, for instance, when he attempted to prevent the collapse of the construction firm Holzmann in 1999 due to illiquidity, presenting the rescue in the evening news and in front of cheering workers of the ruined company – three years later, the firm was gone. Its restructuring plan had failed despite massive public loan guarantees and dumping prices that hurt the already strained German construction sector.

This ad hoc approach is likely to lead to different answers over time, i.e. to time inconsistency, as it reacts to acute problems as they appear, looking at them as singular cases without any consistent line. During his two terms, Schröder has

changed his positions so that laws passed on his initiative had to be undone. In 1998, the limit for firms, for which the lay-off restraint did not apply, was lowered from more than ten to more than five employees – in 2003, the decision was reversed. In 1998, the demographic factor in the pension formula was suspended – now a similar factor will be reintroduced. In 2000, the tax allowance for commuting from home to the work place was enlarged – in 2003, the allowance was reduced. At the end of 2000, the options provided by law for employment contracts of limited duration were reduced - in 2003, newly founded firms were exempted from the regulation in the first four years. In 2001, the business constitution act was tightened under the resistance of the entrepreneurs[16], especially from the Mittelstand – now we are looking for ways how to intensify the investment activity of the enterprise sector. Such varying concepts of economic policy are especially relevant as the state plays a decisive role in the governance system of the German economy. They are particularly damaging in their effects on expectations of entrepreneurs and firms in Germany.

The Governance of Government

Strong elements of cooperative decision-making can also be found in the institutional set-up of government activity itself.

Voting system. The electoral system in Germany is a combination of majority and proportional voting, where each citizen has two votes in the elections for the Bundestag and for the parliaments of most of the federal states. The voting procedures in the municipalities differ among the states.[17] In the elections for the

[16] In the second part of his first term, Schröder leaned towards the interest of the trade unions.

[17] For example municipalities in some states, such as Bavaria, conduct a majority election, while in other states, such as Hessen, local politicians are elected from a party list via a proportional election.

Bundestag, one vote is for the district representative, the other for the party list of candidates. The proportional vote for the party lists determines the relative size of parties in parliament. If a political party carries more districts than it attracts proportional votes, it obtains the direct parliamentary seats as excess seats (*Überhangmandate*), so to say in excess of its proportional weight. The number of parliamentary seats of the federal parliament is expanded accordingly. In this case, the total number of seats is no longer allocated according to the proportional vote. For instance, in the 2002 parliamentary elections to the Bundestag, Social Democrats won 171 seats by direct votes (41.9 per cent) and 80 by party votes (38.5 per cent); the SPD gained four additional seats thanks to the excess mandates in some of the federal states, which represent the geographical areas by which the representation and the excess mandates are determined in the federal election. By contrast, in the same election, the Greens won one district by the direct vote and 55 by party votes (8.6 per cent).

Importantly, however, every party must surpass the hurdle of winning at least 5 per cent of the proportional votes. If it remains below this threshold, the party must carry at least three districts directly to gain party representation in the Bundestag according to the proportional vote. If it receives less than five per cent and if it does not carry at least three districts, the plurality votes will be lost for the party and it will not be represented in parliament. If it carries only one or two districts directly and remains below five per cent, it will only have one or two directly elected members. The five per cent threshold is used to avoid the known outcome of pure proportional voting to produce a great variety of parties with rather specific focus; under these conditions, it is difficult to form a stable government, as the experience of the Weimar Republic has shown. Its decline has been linked to the institutional arrangement of proportional voting (Hermens 1972). The five per cent clause also makes it more difficult for extremist parties

to become permanently established by way of a parliamentary representation as a bridgehead in public attention.

The choice of the voting system has been influenced by attempting to avoid the failures of the past, both the political instability of the Weimar Republic and the concentration of power and disempowerment of democracy in the Nazi period. Whereas the voting system's main feature, the mixture of majority and proportional voting with a cut-off clause for parties failing to command five per cent of the votes, prevents the weaknesses of pure proportional voting by adding elements of majority voting and by the five per cent clause, the institutional arrangement tends not to produce clear majorities each legislative periods. Swings in the vote do change the composition of parliament and the relative strength of political parties, but they usually do not translate into a swing of seats as in a majority voting system. Thus, a party may carry the overwhelming majority of the districts directly and the other party may lose nearly of all its previously held districts, but the proportional vote prevents the same swing from fully becoming effective in parliament. A party losing most of the direct districts can remain partly protected in its parliamentary strength by the proportional votes. Compared to a system of majority voting, swings are partly absorbed. Moreover, it does not lead to a two-party system but allows smaller parties like the Liberal Democrats and the Greens to exist as long as they remain above the threshold of five per cent or directly carry three districts.

Only in 1957 did a single party, the Christian Democratic Union (CDU) - together with its Bavarian sister party, the Christian Social Union -, win the majority of the seats in parliament. The consequence is that in the parliamentary system governments usually are formed by coalitions. Indeed, all German governments have been coalition governments, being centered on the Christian Democratic Union in the periods 1949-1966 and 1982–1998 and on the Social

Democratic Party (SPD) in the periods 1969-1982 and from 1998 to the present (Goetz 2003: Table 1.1). Until 1998, the Liberal Democrats (FDP) were the crucial second party in forming the government in a triangular relationship with the two major parties. Thus, a change of government occurred when they formed a new government with the Social Democrats after the 1969 election replacing the "grand coalition" of the both major parties (1966-1969). Moreover, the FDP switched sides in 1982 during the legislative session by a constructive vote of confidence against Schmidt and the election of Kohl. Only in 1998 was a governing coalition (Christian Democratic Union and Liberal Democrats) voted out of power in favor of an alternative coalition (Social Democrats and Greens).

This system has the advantage that abrupt shifts in policy are prevented. It apparently also allows new paradigms to be introduced by a new party such as the ecological focus by the Greens. This can be seen as a stabilizing feature. But at the same time the system only tends to marginally introduce potentially major changes. One structural reason is that in electoral competition, the two major parties must take into account that a change in the plurality vote in their favor does not transform into a clear majority to form the government alone since they depend on a coalition. Another structural reason is that the two smaller parties in parliament cater to narrowly defined special interest or specific issue groups of voters at the margins of the political spectrum (and in its moderate center) by trying to put clear-cut reform initiatives at the core of the campaigns. These reform-seeking constituencies get skimmed off by either the Liberal Democrats or the Greens. The major parties, then, are left with constituencies that both on the Left and on the Right are more structurally conservative on average than the entire body of German voters. Accordingly they have little incentive to try to appeal with a profile of change and reform.

Thus, in the 2002 elections they have been extremely reluctant to ask for a clear mandate for innovation and not to focus on long-run necessities of change. The voting system makes it risky for the large parties to break away from the traditional lines. Consequently, the new Red-Green government was without a clear mandate and a clear concept for institutional innovations when it started the legislative period in 2002. This leaves a void that is partly filled by interest groups. Apparently, the voting system replicates an important feature of the German governance system whereby consensus among different actors has to be found. In the coalition government itself, a consensus among the parties forming the government has to be permanently established. The cooperative spirit or the consensus approach is enforced upon the government by the voting system.

The alternative would be to move to a majority voting system, where the elected members of parliaments represent the majority of votes in the districts carried. In such a setting, a two-party system would likely evolve. Parties would be forced to orient themselves to the median voter. This approach would prevent extremist parties, and at the same time lead to a government with a clear majority in a legislative period as well as a weakened opposition. However, the opposition would have the chance to win the next election by a clear alternative. In such a system, a decisive check would not come from the cooperation of parties in a coalition government with a threat of new coalitions, but from the opposition taking over. It is a system relying on party competition instead of a blurred system of party competition with coalition formation.

Germany is a representative democracy. It has been cautious introducing elements of direct democracy in the form of popular referenda. Thus, the president of the Republic is elected not in a referendum but by a joint assembly of the Bundestag and the states. Elections of the parliaments of the Bund and the

states are the exclusive means of legitimizing government; the German constitution does not allow competing means of legitimacy (Rudzio 2003:53). In the constitution, plebiscites on the federal level are inadmissible, even if they only should have the role of informing parliaments on the population's preferences. In 1958, the Federal Constitutional Court confirmed the federal system of representative democracy when it ruled against the use of referenda on federal issues by disallowing popular referenda on nuclear armament that were to be initiated by some states. The cautiousness stems from the historical experience of the Weimar Republic, where populist misuse aided in the legal maneuvering to transform the parliamentary democracy into dictatorship. However, a provision is made for decision by referenda in the case of a new spatial delineation of the federal states (Article 29). Referenda in federal states also may be initiated by citizens according to the state constitutions. They, however, have to pass two levels of collection of minimum votes before a binding decision referenda (*Volksentscheid*) must be held, where again a quorum is required. Referenda are also used in the municipalities (allowed in all states with the exception of Berlin), which are only binding if a minimum quorum of voters participated. Moreover, certain issues such as the budget, fees and dues, organizational and remuneration issues are excluded from referenda.

Political Parties. Germany has a relatively stable pattern of two larger and a few smaller parties of political importance. The two larger parties both attempt to attract the median voter (*Volksparteien*) and have thus a very broad spectrum of not very precisely defined goals.[18]

Parliament and government. Germany is a parliamentary democracy in which the Chancellor as the head of government is elected by the federal parliament; he must be a member of parliament. He can be dismissed by parliament through

[18] On a detailed description of the party programs see Rudzio (2003: Table 3) and Conradt (2001:112).

a “constructive vote of no confidence”, meaning that parliament elects someone else with the majority of its votes. Within the government, the chancellor has a strong position because he, not parliament, chooses and dismisses the ministers who are formally appointed and dismissed by the president of the republic. He also has the authority to set the policy objectives of the government (*Richtlininenkompetenz*). The Chancellor needs the support of his party so that parliamentary democracy as defined by the constitution is in fact a party democracy. Major political projects need the approval of the governing parties’ national decision making bodies. The political system is also a representative democracy in which according to the Constitution the will of the people finds its expression through the parties, which are the institutional device by which individual preferences are aggregated.

Schröder has used the corporatist approach of finding consensus in round-tables and committees in which the societal groups, i.e. associations of organized societal interest, were represented. The outcome of these rounds and committees then were more or less okayed by parliament, which did not have many other options since the decisions have been predetermined. In a way, parliament is circumvented by the use of the round-tables and committees to prepare the decisions of the national decision-making bodies of the parties forming the government and thus designing the law projects outside of the genuine legislative process. This raises the constitutional question as to what extent parliament has been disempowered by this approach to the advantage of organized interest groups. These groups do not represent the common interest nor are they in any way representative of the population or of the preferences of the population expressed in an election. They merely represent the interests of their specific group. Often not even the concerns of their members come first, but rather the interest of their organization interest. This raises the issue as to how much power and influence should interest groups be allowed in

parliamentary democracy. Corporatism, in fact, is not only an obstacle to economic efficiency, growth and innovation but it stifles the democratic process by attempting to short-cut it by way of supposedly representative organized groups. That democracies are prone to be influenced by lobbying groups is a problem that arises per se out of the intricacies of collective action (Olson 1971). However, surrendering the decision-making processes directly to those interests that find the power to organize means to accept outcomes that run counter to the societal optimum. It may be but a mere democratic façade to a rather oligarchic system.

Bundesrat and Lawmaking. The federal character of Germany becomes apparent, among other aspects, in the role that the Bundesrat, the decision-making body representing the sixteen Länder, plays in lawmaking as defined by the German constitution in which one third of the articles relate to aspects of federalism. To choose a two-chamber system with an important role of the Länder in political decision making and with the Länder as check to the central government, can be interpreted as taking in the lessons of Germany's past, together with choice of the voting system. In principle, law making competences are with the Länder unless specified otherwise (Article 30). An important concept is how the legislative competence is allocated to the federal level and the federal states. The federal level has the exclusive legislative competence in foreign affairs, defence, citizenship, the free movement of people, immigration (subject to the conditions of Article 74), the organisation of the monetary system and the postal system, telecommunications, the railroads and air traffic and some other areas (Article 73). In competing legislative competence both the federal states, the Länder, and the federal level, the Bund, must cooperate. As a principle, the competence lies with the Länder unless the Bund takes the initiative. In such a case, the Bundesrat has to agree, it thus has a veto. The competing competence extends to civil and criminal law, the legal system, the

registration system of citizens, the right of domicile for foreigners (see immigration above), labor law, the Labor Office and unemployment policies, social insurance, the constitution of firms, expropriation, public welfare politics, labor law, scientific research and other areas (Article 74). Schools, universities, culture and broadcasting (all three subject to the framework competence of the federal layer, see below), regional economic policy and local government belong to the competence of the states; this follows from article 30. In addition to these two forms of lawmaking competence, the federal level has the right to establish a common institutional framework for the country in order to have similar conditions and to guarantee the legal and economic unity of the country. This framework competence relates to higher education, the legal system, the media, the protection of nature and other areas (Article 75).

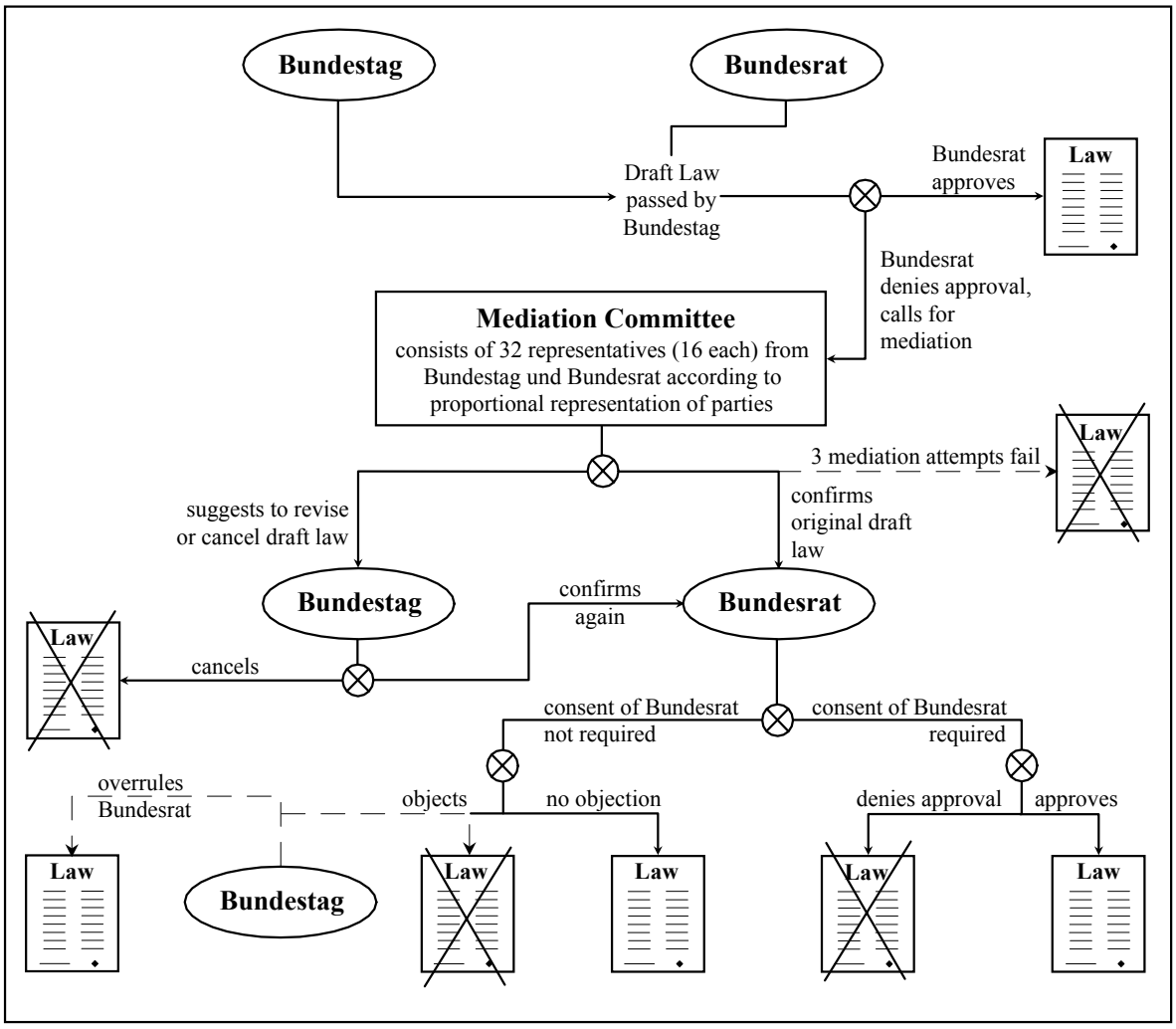
Historically, the Länder have lost powers in two developments. In 1969 and the early 1970s, the cooperative element in federalism was expanded by some constitutional changes (Jeffery 2003). In 1969, the income tax, the corporate income tax and the value added tax became shared taxes whose revenue is distributed between the federal level and the Länder according to proportions agreed upon. Moreover, a revenue-sharing mechanism between the Länder was introduced. A number of tasks also have been defined as joint tasks with co-financing in such areas as university construction, regional economic policy and agriculture (Article 91a). Co-financing became possible for major infrastructure projects. Such changes meant joint planning and thus a loss of autonomy for the states. In a second development in the late 1980s and in the early 1990s, many national powers had to be transferred to the European level in the context of establishing the single market. These transfers included powers of the Länder, meaning that the Länder lost part of their competence to the European level. During the Maastricht negotiations the Länder succeeded to introduce a new article into the constitution (article 23) that gave the Länder a veto over the

transfer of power to the EU level so that they now can influence whether parts of their sovereignty can be assigned to the EU level.

The Bundesrat is made up by the representatives of the governments of the Länder. Each of the states has a number of votes graduated in proportion to its population; the votes of a Land have must be cast en bloc. The Bundesrat can initiate laws, and is involved in lawmaking in several other respects. It has to be informed of the laws passed in the Bundestag and if it does not agree with the law, it can request the creation of a mediating committee (*Vermittlungsauschuss*) consisting of 16 members each from the Bundestag and the Bundesrat in proportion to the political majorities. The creation of a mediating committee can also be requested by the government and the parliament. This applies when a law has been initiated by the Bundesrat. If the mediating committee proposes a change to the law, the Bundestag has to vote again. In this context, two different type of laws have to be distinguished. With respect to laws where the consent of the Bundesrat is not required and where it does not have a veto, the Bundesrat can express its objection. This objection, however, can be overruled with the majority of the members of the Bundestag. This is not the majority of the members present but the majority of all members elected (chancellor majority). The qualified majority of two-thirds of the members of the Bundestag is needed if the vote of the Bundesrat was taken with two-thirds of the votes of the Bundesrat. With respect to laws for which the majority of the Bundesrat is required according to the competing law making competence, the veto of the second chamber cannot be overruled. If no agreement in the mediating committee can be reached after three attempts, the law is not passed. When the majority in the Bundestag, i.e. of the parties forming the government, is identical to that of the Bundesrat, the role of the second chamber is to express the interest of the federal states and require

changes that run counter to their interest. When the majorities differ, party considerations play a major role.

Figure 3: Lawmaking by the Bundestag and the Bundesrat



A reform of federalism. This institutional set-up of decision making in which the federal level and the Länder have to agree on new laws has expanded in the past. It is estimated that the competing competence has applied to 60 per cent of all the federal laws passed. This institutional arrangement which is intended to bring about a consensus has blurred the clear responsibilities of the different federal layers. It has taken away responsibilities and autonomy from the Länder. At the same time, when political majorities in the Bundestag and the Bundesrat

diverge, the procedure's intent of mediating between the interest of the federal layer and the interest of the Länder changes into a bargaining set-up between the two major parties. If decisions are found, the set-up can be called a grand coalition trying to find a compromise along the lowest common denominator. It may be seen as a cooperative government superseding the existing system as the president of the Constitutional Court, Papier (2003), wrote.

An example for this role was the negotiations in the mediating committee in December 2003, where 16 reform laws of the Red-Green coalition were dealt with. Under these circumstances, a major change of orientation as a response to changed external conditions or to external shocks is difficult to reach. Modernization becomes less likely, and the system tends to stall. A grand coalition may be one interpretation. An alternative one, that also represents a possible outcome, is that the opposition in the Bundestag can use the intermediating committee to block reforms proposed by the national government. For the country, this means a deadlock. When the voter holds the national government liable for policy failures that he observes, the institutional set-up is a lever for the opposition to get the acting government out of power by blocking the reforms that would have alleviated the situation. This happened prior to the 1998 election when Lafontaine in 1997, then prime minister of the Saarland and leader of the Social-Democrats, used the Bundesrat to block the tax proposals – the Petersberger Beschlüsse - passed by the Bundestag during the Kohl government.

The difficulties created by this system of governance of the government necessitate reforms. The changes of 1969 and the early 1970s leading to a more intense cooperative federalism have to be corrected. The mixed responsibilities of the federal level and the Länder should be disentangled by transferring back competences to the Länder according to the subsidiarity principle. The domain

of the competing lawmaking competence should be pushed back to a few clearly defined problem areas, while the framework competence of the federal level must be curtailed to allow competition between the Länder. Then the federal states would be in a better position to pursue their independent policies. They must have their own taxes which generate enough revenue so that they can fulfil their clearly defined tasks. This means that the notion of "joint tasks" should be given up, and the revenue sharing from the main taxes should be reduced. Horizontal revenue sharing must also be downgraded. A precondition for this change, however, is that the Länder are viable units. This implies that the geographical delineation of the Länder must be revised so as to produce a smaller number of federal states.

An alternative to this approach would be to replace the Bundesrat, as a representation of the Länder, by a senate whose members are directly elected and thus are not representatives of the Länder governments, as proposed by Papier in the above mentioned article. The governments of the federal states then would loose the direct influence on federal policy.

The Constitutional Court. Whereas it has been the role of the Constitutional Court to examine the constitutionality of laws passed (and the of the decisions of the lower courts), the Court has more and more come into a role to solve problems that the political process was unable to tackle. Thus, it has forced the political parties as well as the federal government and the federal states to set up criteria and to find a new formula for the revenue sharing between states in its 1999 ruling. It also has defined an upper limit for taxation in that the state is not allowed to take more than a half of citizen's income in the form of taxes in its 1995 ruling. Such rulings are the consequence of a stalemate of the political process in Germany. Politicians, when unable to come up with a solution to a specific issue, just wait until the Constitutional Court has spoken. This then

forces a compromise on politics; it also serves as a constraint for interest groups. Thus, the Constitutional Court gets into the role of shaping important aspects of the economy. It becomes a substitute for parliament and disempowers it. This is an additional disempowerment of parliament besides the role of the interest groups. The role to define the upper and lower bound of practical solutions or to even predetermine practical economic answers is problematic for a constitutional court since it is not in the position to evaluate all the implications of its suggestions in a general equilibrium framework. Here a critical economic evaluation of the Constitutional Court's decisions is still lacking.[19]

The Restrained Market Economy

Looking at the governance approach used in Germany, the social market economy is a restrained market economy. In many areas, the institutional set-up moves decisions away from the market process and from competition and assigns them to the government, to social groups, organizations and informal relationships (Table 1).

[19] Compare the annual reviews of the US Supreme Court decisions by the Cato Institute.

Table 1: Cooperative Decision-Making versus Markets and Competition

Area	Cooperative Decision-Making	Markets and Competition
Employment	Wage formation and institutional setting by social partners	Labor markets determining the equilibrium wage
Banking	Bank-intermediated products, relationship-banking	Capital market intermediated products
	Public guarantees, protection against take-over	Market control by the threat of take-over
Governance of firms	Two-tier board system, control by the supervisory board	Strong reliance on the capital market and the threat of take-over
	Codetermination in the supervisory board	No formal restraint on the decision space
	Workers' councils	Self-interest of the firm to be attractive to its employees
Health	Associations of statuary health insurance physicians in the public health system	Competition of integrated systems of insurers and health service providers
Universities	Governmental administrative planning of the university sector	Competition among universities
	Entitlement to free access	Scarcity prices for students
Steering the economy	Round tables and committees (consensus approach)	Decentralized decisions via markets
Governance of government	Cooperative federalism	Competitive federalism
	Mix of majority and plurality voting	Majority voting

Decisions are moved away in many sub-spheres of the economy from the market mechanism. The institutional arrangements interact with each other. Thus, strong product market regulations are likely to entail strong labor market regulations and vice versa. In a diagram with employment protection on the vertical axis and product market regulation on the horizontal axis, Germany lies to the right and above the Anglo-Saxon countries (Council of Economic Advisers 2002/03, Figure 57). In another diagram with the same vertical axis and stock market capitalization, it has a low stock market capitalization (Hall and Soskice 2003, Figure 1.1). If full-time equivalent employment is considered, Germany exhibits a relatively low figure, together with the Scandinavian countries (Hall and Soskice 2003, Figure 1.2).

Instead of letting decisions take place in a decentralized way in the markets and by competition, the German approach seeks to establish consensus and relies on non-market processes. Unlike in the US, German public opinion does not ask first “Where is the market solution?” when a new problem arises, but it nearly instinctively looks at the intervention of the politician for a solution. Non-market approaches get an implicit preference, there is even a deeply rooted mistrust of markets and competition, possibly more so after German unification. The non-market processes are often thought of as protecting the collective interest including the aspect of equity whereas it seems difficult to understand for the public that the aggregation of decentralized market decisions and competitive processes lead to efficient results for the economy and also stimulate dynamics. Thus, whereas Germany has prevailed over the extreme form of collectivism in Eastern Germany, soft forms of collective decision-making continue to exist.

It is the hypothesis of this book that Germany has lost economic dynamics due to its institutional set-up. Its institutions favor the status-quo and consequently make economic development extremely path-dependent. Given technological

trajectories and long-practiced organizational approaches dominate the road to the future, allowing marginal improvements in the familiar areas of production, but the conditions are not incentive-compatible for leapfrogging. In contrast, other countries, especially the small and foreign trade-oriented economies in Europe, have changed their institutional arrangements as a response to new challenges in the world economy.

This leads to the fundamental question whether and to what extent Germany has become immobile with respect to institutional modernization. One answer is that the institutional arrangement is the expression of political preferences of a country. Given these preferences, a trade-off exists between the wish for collective decisions and the performance of the economy. Who wants more collective choices instead of markets and competition has to pay the price of a lower economic dynamics. This may well be the decision of a mature economy having reached a satisfactory level of income to allow itself the luxury of consensus-seeking solutions.[20] Then, relative decline in comparison to other countries is certain to come, and absolute economic decline cannot be ruled out.

The other answer is that the institutional structures have become so rigid that institutional adjustment can no longer take place and that vested interests have captured the institutional set-up and control it to such an extent that the political process has lost its problem-solving capacity. Then a country like Germany must rely more and more on decisions of the Constitutional Court to unblock political deadlocks. In such a scenario, Germany can indeed be compared to Japan as another mature economy.[21] In that sense, Germany may face a similar problem as Japan Their institutional systems were appropriate for expanding economies,

[20] As an indication of this conflict see Figure 1.2 in Hall and Soskice (2003) with a similarly low Gini coefficient as the Scandinavian countries indicating a more equal distribution, but also a low full-time employment equivalent.

[21] For Japan, the reason for politcal immobility is seen in the relative over-representation of agricultural voting districts to the city districts finds its analogon in the consensus approach in Germany.

but no longer seems to be appropriate to solve structural issues. We then have the new category of NDC's in the world economy, the newly declining countries.

I do not believe that is the inevitable answer for Germany. The institutions are not completely captured by political groups, and with enough energy and resilience, the country can find a way out of deadlock in which it finds itself.

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