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POLICY EXPERIMENTATION AND THE SEARCH FOR INSTITUTIONAL  
CHANGE:  
THE POLITICS OF  
RED-GREEN REFORM IN GERMANY

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The first coalition government in Germany between Social Democrats and Greens aimed primarily at reform legislation in a series of policies. This paper examines three policy areas of direct concern to business – job creation, codetermination, and tax policy. It argues that the coalition suffered an initial defeat in job creation and then settled into a de facto strategy of incremental reform through experimentation in the areas of codetermination and tax policy. This strategy resulted from tensions rather than agreement between the coalition partners. While the Social Democrats pressured organized business and organized labor toward compromise, the Greens wanted to undermine the encompassing control of these organized groups by bringing a broader set of constituencies into the policy process.

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## **Policy Experimentation and the Search for Institutional Change: the Politics of Red-Green Reform in Germany<sup>1</sup>**

Scholars in comparative politics have for most of the period since 1945 portrayed the German political economy as an important case of incremental adjustment to changing conditions of international competition. In contrast to earlier decades, however, the years since unification in 1990 have witnessed clear efforts to alter basic elements of the social market economy that powered the Federal Republic's postwar growth trajectory. Grouped together under the rubric of social and economic reform, legislative initiatives in several domains – including collective bargaining, unemployment benefits, pension financing, tax policy, and corporate governance -- have set in train a potentially transformative process of change.<sup>2</sup> For this reason, the recent debates over social and economic reform provide a rich record for assessing alternative perspectives on institutional evolution.

The now widely accepted views of incremental evolution in postwar Germany typically include a realm of experimentation where gradual adjustment takes place and accommodates forces which under earlier arrangements might have weakened or entirely swept away the larger political order. According to Peter Katzenstein, for example, the large institutional blocks of a centralized society – particularly the business associations and the trade union confederation – were well suited to aggregate shifting interest-group preferences and convey them to the political arena. Whether it deserved the label of neo-corporatist bargaining or some lesser form of concertation, the norms of structured negotiation between the social partners made it possible to accommodate changes in technology and other market conditions without revising underlying features of the West

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<sup>2</sup> For an excellent overview, see Anke Hassel and Hugh Williamson, "The Evolution of the German Model; How to Judge Reforms in Europe's Largest Economy," Paper prepared for the Anglo-German Foundation, Berlin, January 2004.

German economy.<sup>3</sup> This pattern of adjustment occurring “below the radar screen” of high politics meant that Germany fitted uncomfortably into the image of punctuated equilibrium that comparativists found convenient for many other countries. Building upon Katzenstein’s earlier work, Kathleen Thelen has recently shown that patterns of incremental change can be traced back to the 1920s and even the 1890s in particular institutional domains like vocational training. The compromises that supported joint investment in skill accumulation survived even the catastrophic ruptures of the 1930s and 1940s to reemerge in the postwar decades.<sup>4</sup> Elaborating these perspectives, Thelen and other authors have argued that the category of incremental change includes a considerable range of mechanisms that add up to gradual transformation. According to this view, graduate transformation may be more prevalent than the stark alternation of rupture and continuity posited by punctuated equilibrium.<sup>5</sup>

In addition to the rate of institutional change, the scope of institutional change has attracted growing interest. Put more precisely, prior debates relied on the Schumpeterian distinction between radical versus incremental change to illuminate the magnitude of discrete changes that occurred within short durations. Were they dramatic all-embracing changes (radical) or small steps (incremental) that might comprise part of a more gradual though extended adaptation? A more recent set of debates focuses on a conceptually distinct question: the nature of the links among the separate institutional elements that may be changing. Are institutions tightly or loosely coupled? Irrespective of the magnitude of change (radical or incremental), can one piece of an institutional constellation change independently of others, or must the elements of an institutional order change simultaneously?

This question of piecemeal versus holistic change matters for Germany because so many accounts put dense or tightly coupled institutional arrangements at the center of the country’s adjustment capabilities. According to the Varieties-of-Capitalism

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<sup>3</sup> Peter J. Katzenstein, Policy and Politics in West Germany: The Growth of a Semisovereign State (Phila: Temple University Press, 1987); Peter J. Katzenstein, “Industry in a Changing West Germany,” in idem., ed., Industry and Politics in West Germany: Toward the Third Republic (Ithaca: Cornell University Press, 1989).

<sup>4</sup> Kathleen Thelen, How Institutions Evolve: The Political Economy of Skills in Germany, Britain, the United States, and Japan (Cambridge University Press, 2004).

<sup>5</sup> Wolfgang Streeck and Kathleen Thelen, eds., Beyond Continuity: Institutional Change in Advanced Political Economies (NY: Oxford University Press, 2005).

approach, these tightly coupled arrangements can be described as institutional complementarities that contribute powerfully to the country's aggregate performance. This view implies that complementary institutions should change in parallel with one another. An alternative view is suggested by the concept of hybridization. If complementarities suggests that an institutional order should change holistically, the concept of hybridization suggests that separate institutions can change asynchronously. Particularly when models and practices diffuse from other countries, studies of hybridization suggest that these elements diffuse on a piecemeal basis, which is precisely why they are "adapted" as actors insert them into an institutional context different from the one in which they originated.

In order to assess these two views –complementary change versus hybridization – this paper compares the politics of employment policy, corporate taxation, and plant-level governance. Since linkages among these three areas supply key features of Germany's social market economy, policy debates surrounding their modification should reveal whether or not political actors see them as tightly linked through complementarities or other functional interdependencies. While institutional changes can proceed from sources other than public decisions, policy debates nonetheless show us how self-conscious efforts at institutional change are understood by actors with decision-making powers.

On the basis of these three policy domains, we argue that German elites in the first four years of the red-green coalition pursued institutional change on a piecemeal basis in which some elements of inherited arrangements can be changed while others remain the same. Both the federal cabinet and the party caucuses in the Bundestag are constrained more by electoral politics than by functional characteristics of the institutions they seek to modify. At a more general level, if complementarities or other tightly coupled institutional dependencies emerge, they do so only after the politicians have figured out "what works" in the political arena. If anything, the Chancellor and the coalition partners have displayed a pattern of experimenting with different policy packages to learn which of them might lead to a stable reconfiguration of Germany's economic institutions. Accordingly, we describe the mechanism of change apparent in these debates as a process of policy experimentation in the service of institutional search.

The paper proceeds in three main steps. First we consider recent debates on institutional change, emphasizing the contrast between institutional complementarities versus institutional hybridization as different starting points for a theoretical explanation of the German case. Second, we sketch the institutional arrangements that dominate Germany's political economy and identify the challenges that appear to confront these institutions with the need for change. Third, we analyze three specific cases of attempted institutional reform – in employment promotion, tax policy, and the joint governance or “codetermination” of industrial firms. Finally, we offer concluding remarks on the implications of these cases for our understanding of the nature of the linkages among different domains of institutional change in the German economic order.

## I. CURRENT DEBATES ON INSTITUTIONAL CHANGE

Efforts to develop a more elaborate typology for mechanisms of incremental institutional change grew out of earlier debates that revolved around the notion of punctuated equilibrium. According to this view, enunciated by Stephen Krasner,<sup>6</sup> the rules and practices that count as institutions tend to persist with minor adaptive changes until those moments of exogenous disruption, when dramatic changes are suddenly possible. This view has been substantially improved and refined through the concept of path dependence as applied to politics from studies of technology and economic history.<sup>7</sup> Yet, the strict opposition between critical junctures and longer periods of self reinforcing continuities seemed inadequate to a number of scholars, especially those who were trying to describe the blend of flexibility and rigidity in countries including Japan as well as Germany. For these cases and several others, institutional reproduction itself rested on processes of politics and negotiation that seemed to require a more varied vocabulary.

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<sup>6</sup> Stephen D. Krasner, “Approaches to the State: Alternative Conceptions and Historical Dynamics,” *Comparative Politics* 16”2 (January 1984): 223-246.

<sup>7</sup> Paul Pierson, “Increasing Returns, Path Dependence, and the Study of Politics,” *American Political Science Review* 94 (2000): 251-267 and James Mahoney, “Path Dependence in Historical Sociology,” *Theory and Society* 29 (2000): 507-548.

The notions of institutional complementarities and institutional hybridization suggest two different ways of conceptualizing such processes of incremental change.

Complementarity is a firm-level result raised by the Varieties of Capitalism literature to the level of national institutional arrangements. At the level of the firm, complementarity designates a relationship between inputs (e.g., skilled labor and production technology) and an output function in which increasing levels of either input, holding the other output constant, has outsized effects on output.<sup>8</sup> At the level of national institutional arrangements, complementarity describes a functional relationship in which one institution (e.g., centralized wage bargaining) enables investments that enhance the effect of another institution (e.g., inflation-fighting central banks).<sup>9</sup>

Although the link between firm-level and national-level complementarities remains unclear, there is significant evidence that complementarity effects exist at the national level. By constructing a coordination index across OECD countries, Peter Hall and Daniel Gingerich have shown that the key institutional features associated with coordinated market economies tend to cluster together. They are also able to show – in keeping with the Varieties of Capitalism approach – that countries which score either high or low on their index display better macroeconomic performance than countries in the middle. That is to say, countries whose institutions fit the picture of coordinated economies or liberal economies do better than countries with a mix of institutional features.<sup>10</sup>

As these authors acknowledge, the beneficial performance effects of complementarity are analytically distinct from their implications for institutional change. While complementarities at the firm-level may be created through managerial decisions about human resources or investments in technology, they emerge differently at the level of national institutions. Robert Boyer make this point when he says, "the notion of

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<sup>8</sup> Paul Milgrom and John Roberts, "The Economics of Modern Manufacturing: Technology, Strategy and Organization," *American Economic Review* 80 (1990): 511-528 and idem., "Complementarities, Industrial Strategy, Structure and Change in Manufacturing," *Journal of Accounting and Economics* 19 (1995): 179-208.

<sup>9</sup> Peter A. Hall and David Soskice, "An Introduction..." *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford UP, 2001), 1-70.

<sup>10</sup> Peter A. Hall and Daniel W. Gingerich, "Varieties of Capitalism and Institutional Complementarities in the Macroeconomy: an Empirical Analysis," Discussion Paper 04/5, Max-Planck-Institut für Gesellschaftsforschung, 2004.



institutional complementarity seemingly translates at the macroeconomic level into the theory of super-modularity ..., but the underlying mechanisms are quite different: institutional complementarity is observed only ex post and does not derive from organizational or technological complementarity."<sup>11</sup> Or, as Wolfgang Streeck puts it, we need to explain the origin of institutional complementarities "in the absence of a grand design or a master designer." According, the process of adjustment and refinement that improves institutional outputs by "making them more complementary , must be conceived largely as taking place 'on the ground' and bottom-up, by discovery, improvisation, or serendipity."<sup>12</sup>

If institutional complementarities re achieved only gradually and in part unintendedly over time, any change in such beneficial arrangements is likely to have distributive effects that are keenly perceived by political actors at the time. Peter Hall points to work on cross-class coalitions as a case where actors (e.g., Swedish employers) anticipated the complementary effects of new social policies (e.g., universal pensions) with existing arrangements (centralized wage setting) and moved to create such effects. In cases where existing complementarities are altered, however, the negative distributive effects are likely to be clearer. When we look at cases of institutional "reform" in coordinated market economies, we are more likely to be examining the dismantling of complimentary linkages. In such cases, according to Hall, we "should acknowledge that it is often not their aggregate effects per se, but the distribution of actor-specific effects, that is most crucial to the relevant processes of institutional creation and change."<sup>13</sup> Even in these cases, however, actors may not anticipate the negative effects of losing such linkages and the complete set of losers may not be identifiable ex ante.

An alternative perspective is provided by the concept of hybridization. In a group of studies that examine the spread of American production strategies after World War Two, Jonathan Zeitlin and Gary Herrigel use the term "hybridization," to designate a broad range of diffusion experiences in which European and Japanese industrialists took models of technology and organization from the United States and adapted them to the

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<sup>11</sup> in Colin Crouch, et; al., "Dialogue on 'Institutional Complementarity and Political Economy,'" Socio-Economic Review , 3 (2005): 359-382, page 367 for quoted sentence.

<sup>12</sup> Ibid., 364.

<sup>13</sup> Ibid., 377.

tasks of postwar reconstruction.<sup>14</sup> In these cases, hybridization was no neutral analytic concept, but rather a “contested historical project” in which different actors proactively sought out models that served their political purposes. In these earlier postwar decades, the tasks of adapting such models was attended by “radical uncertainty” that led to real innovation and learning as the imported models collided with local institutions and circumstances.<sup>15</sup>

In more recent decades, a similar process of diffusion fits some of the changes observed in corporate governance. For at least one aspect of corporate governance in Germany, the relationship between owners and managers, Martin Höpner sees a clear process of diffusion by which the “shareholder orientation” gained traction among German firms. This new orientation militated against the domination of corporate boards by representatives of the house banks that provided long-term financing, and opened the door to a more active market for hostile takeovers. There was little doubt that this orientation was imported from the United States through a mixture of “external and internal impulses.”<sup>16</sup> In the case of Germany, the shareholder value movement was explicitly supported by U.S. based pension funds, including Calpers, which backed German shareholder associations as a politically acceptable means of supporting minority shareholder rights and a more open market for corporate control.<sup>17</sup>

Not surprisingly, the spread of shareholder-friendly rules of disclosure, board composition, and ownership made observers wonder whether the other lynchpin of Germany’s stakeholder-value approach to enterprise governance – codetermination – might also be changed. In this sense, the opening of Germany’s system of corporate finance has triggered a real-time experiment for the complementarities or mutually beneficial effects of “patient capital” and strong forms of employee representation. The question is whether, without long-term equity commitments from their financiers, German firms will seek to jettison the strong stakeholder ties that shaped their ties via codetermination to their workforce. Through the first four years of red-green

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<sup>14</sup> Jonathan Zeitlin and Gary Herrigel, eds., Americanization and Its Limits: Reworking U.S. Technology and Management in post-War Europe and Japan (Oxford: 2000).

<sup>15</sup> Zeitlin, “Introduction,” 18, 19, 34.

<sup>16</sup> Martin Höpner, “What Connects Industrial Relations and Corporate Governance? Explaining Institutional Complementarity,” *Socio-Economic Review*, 3 (2005): 331-358.

<sup>17</sup> J. Nicholas Ziegler, “Corporate Governance and the Politics of Property Rights in Germany,” *Politics and Society*, 28:2 (June 2000): 195-221.

government, the pattern of liberalizing industrial finance while reinforcing the rules of codetermination continued. There was little apparent political logic and no compelling functional logic to lead policymakers to conclude that liberalization on the finance side of corporate governance required liberalization on the employee side.

On the contrary, in keeping with the concept of hybridization, German policymakers adopted rules for more flexible and open financial ties but refrained from altering other key aspects of corporate governance into which the new financial practices had to be implemented. The collision between new modes of finance with longer-term committed links between German employers and their employees was expected to generate new forms of adaptation and innovation.<sup>18</sup>

The politics of economic reform under Germany's first red-green coalition, 1998-2002, illustrate both the consequences of dismantling institutional complementarities and the process of hybridization. When he succeeded Helmut Kohl as Chancellor in September 1998, Gerhard Schroeder confronted higher unemployment than faced by any previous chancellor from the Social Democratic party. In the election campaign, Schroeder sought to identify a moderate centrist constituency (the "Neue Mitte") that would support economic modernization without alienating the Social Democrats' base in organized labor. The environmentalist Greens, who were junior partner in the government, brought a new set of preferences into the federal government for the first time. After their emergence as an anti-nuclear movement in the 1980s, the Greens came to articulate an elaborate set of post-industrial and anti-authoritarian preferences that fitted at best uneasily into the Left-Right politics of Germany's earlier postwar spectrum of Germany's prior electoral history.<sup>19</sup> This uneasy synthesis of party commitments provided an unpredictable foundation for the new coalition's efforts to reconstruct the pillars of Germany's social market economy. The Social Democrats oscillated between new plans for economic openness and older commitments to inherited values of solidarity. The Greens meanwhile sought to temper all recipes for growth with commitments to individual autonomy and ecological protection. In the process of forging policy strategies, the new coalition imported many ideas and some policy models from

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<sup>18</sup> Zeitlin, 18.

<sup>19</sup> Herbert Kitschelt, "Left-Libertarian Parties: Explaining Innovation in Competitive Party Systems," *World Politics*, 40:2 (Jan. 1988): 194-234.

abroad while adjusting existing commitments to other inherited features of Germany's social market economy.

## II. THE GERMAN MODEL AND THE CHALLENGES OF ECONOMIC REFORM

The tasks of economic reform that faced the Red-Green coalition in 1998 grew out of the same mix of rigidities and adjustment capacities that had generated conflicting images of Germany economic performance for almost two decades. On the one hand, as a powerful industrial exporter, Germany invariably led the world's export tables on a per capita basis and often on an absolute basis. On the other hand, the country's payroll financed welfare policies made it extremely costly for firms to create new jobs. As unemployment moved into two-digit levels through in the 1990s, a proportionately smaller force of wage earners contributed to the funds that were needed to finance benefits for the growing ranks of the unemployed. Commentators spoke increasingly of the "employment crisis of the German welfare state." (Manow, 2000). Both aspects of Germany's economy – its competitive strength in high value-added markets and its inability to create new job growth – reflected different pieces of the same institutional anatomy. Peter Katzenstein earlier described this anatomy as a combination of decentralized state institutions and centralized societal institutions that represented key economic interests groups. While the decentralized state exercised only "semi-sovereign" authority over policymaking processes, the highly organized structure of economic interest groups – particularly union and employer associations – created sharp distinctions between those interests that enjoyed a strong

voice in policy making and those that were excluded. This system of interest representation maintained a clear difference between groups that are “insiders” and “outsiders.” This insider-outsider division was the most important symptom of an economy that for many of its members provided “welfare without work.”<sup>20</sup>

Even as unemployment persisted, the export oriented sectors of Germany manufacturing economy performed well. These were the sectors that produced steady growth with high wages by serving high value-added niches in world markets. These sectors represented the core of Germany “coordinated market economy” in which capital and labor jointly negotiated long-term commitments to robust product strategies.<sup>21</sup> The institutions that facilitated this pattern of negotiated adjustment included: autonomous and patterned wage bargaining; an independent central bank inclined toward monetary restraint; high quality standards in products and production; extensive vocational education; and firm-level codetermination. In this tightly interwoven set of arrangements “wage autonomy” granted large industrial unions and sectoral employers’ organizations a monopoly over the representation of employee and employer interests in collective bargaining, which is insulated by constitutional provisions from state intervention. The “patterned” element of wage bargaining meant that the largest industrial union (IG Metall) and the metal industry’s employer association (Gesamtmittel) traditionally negotiated pilot contracts that become the standard – and provided relative predictability - - for labor negotiations in other sectors. The Bundesbank’s independence enabled it to impose monetary restraint and to signal clear macroeconomic parameters within which the social partners could anticipate the effects of their behavior in wage negotiations.

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<sup>20</sup> Esping-Andersen

<sup>21</sup> Peter Hall and David Soskice, “Introduction,” in idem., eds., Varieties of Capitalism: The Institutional Foundations of Comparative Advantage, (Oxford/NY: Oxford University Press), 1-68.

High quality standards were maintained by the elaborate network of employer and producer associations that sought to maintain industry-wide reputations for goods “made in Germany,” thereby inducing firms to compete more on quality than on price. To enable such production, the business associations and unions supported an extensive framework of vocational training that provided three-year apprenticeships to more than 50 percent of Germany seventeen year-olds. Finally, works councils integrated employee representatives into firm-level decision-making, while prohibiting them, legally, from participating in wage negotiations. Codetermination thus permitted a firm’s employers and employees to collaborate in pursuit of common interests, while wage-bargaining arrangements took conflicts over compensation out of the firm by elevating them to the sectoral level.

In Germany’s core export industries, these institutional arrangements brought the organized social partners into a virtuous circle. High wages for skilled labor pushed employers and unions toward further cooperation in strategies for competing in high value-added product markets. The accumulated quality bias of management worked in tandem with the downward “stickiness” of wages to keep firms focused on high-quality market segments, often for semi-custom durables, instead of more price-competitive businesses.<sup>22</sup> Conditioned by the Bundesbank’s commitment to monetary stability, wage gains in successful exporting sectors were transmitted throughout the economy via patterned bargaining and umbrella wage agreements. High but predictable wage levels, in

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<sup>22</sup> For a more developed discussion of this dynamic, see Wolfgang Streeck, “On the Institutional Conditions of Diversified Quality Production,” in Beyond Keynesianism, edited by Egon Matzner and Wolfgang Streeck (Aldershot: Edward Elgar, 1991).

turn, reinforced industry-wide incentives to invest in human and material capital.<sup>23</sup> While this model was well suited to such sectors as machine tools, transportation equipment, and specialty chemicals, it fitted less easily with the needs of the newer service sectors and other pursuits in advanced market economies. The privileged place of certain unions and employers' organizations in the German economy amplified the influence of manufacturing industries at the expense of employers and employees in other sectors, especially those in the emerging service sector.

The reverse side of Germany's export success in core manufacturing sectors was a welfare state that disadvantaged a growing number of employees and potential employers in other sectors. In conditions of low unemployment, such as those enjoyed from the 1950s through the 1970s, West Germany's welfare state effectively ended old-age poverty and buffered workers (and their families) against loss of wages owing to sickness or unemployment. Changes since the 1970s have, however, made these same policies especially advantageous to an ever more narrow segment of firms and workforce at the expense of potential new entrants. The costs of these policies, distributed across the high wages of established sectors, particularly discouraged new enterprises in low-wage services, thereby reinforcing barriers between industrial "insiders" and a growing number of unemployed and new firms who remained "outsiders" to the political process.

The German welfare state, like others in Continental Europe, relied heavily on the concept of male breadwinners who supported nuclear families through lifetime employment in stable companies. In addition, the early postwar architects of German social policies oriented them around the principle of status-preserving benefits for

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<sup>23</sup> Margarita Estevez-Abe, Torben Iversen, and David Soskice, "Skill Formation and the Welfare State," in Hall and Soskice, Varieties of Capitalism.

different occupational groups rather than fully egalitarian or leveling principles for all citizens. Accordingly, the German welfare system came to rest upon large, para-public insurance schemes rather than the public provision of universal welfare benefits to protect all individuals, regardless of prior employment. These insurance schemes tied insurance protection to employment by making them financially dependent on payroll contributions from employers and employees. Through these provisions, German social policy embodied a conception of society and workforce organization that was characteristic of the leading market economies in the first two-thirds of the last century.

These features of Germany's welfare state combined over the past two decades to produce a "pathological response pattern" that effectively excluded a growing number of employers and employees from full participation.<sup>24</sup> This dynamic only became visible in the later 1970s and 1980s when the insatiable need for new labor that characterized earlier decades disappeared. Bundesbank independence and fragmented fiscal federalism undercut the ability of state agencies to combat recession through expansionary fiscal or monetary policy. Because the collective bargaining system made it difficult if not impossible to adjust wages downward, reduction of the supply of labor quickly became the most practicable response to economic downturns. Without the capacity to stimulate the economy or to drive wages down, state officials and firms were induced to remove labor from the payroll to the rolls of the unemployment, pension, and healthcare systems. Since these insurance schemes were financed directly by contributions from the employed and their employers, however, moving individuals from employment to welfare, had the perverse effect of increasing taxation and the real cost of labor. Such

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<sup>24</sup> Philip Manow and Eric Seils, "Adjusting Badly: The German Welfare State, Structural Change, and the Open Economy," in F.W. Scharpf and V. A. Schmidt, eds., Welfare and Work in the Open Economy, Vol. II., "Diverse Responses to Common Challenges," (New York: Oxford, 2000).



increases in the cost of labor exacerbated the existing disincentives that discouraged employers (and potential new entrants) from creating new jobs. German unification accelerated this dynamic by dumping a disproportionate number of unemployed East Germans into the welfare insurance system. The virtuous circle of earlier decades had by the 1990s become a vicious cycle.<sup>25</sup>

Beyond raising fears of fiscal collapse, this cycle of rising social contributions to be paid by a shrinking proportion of the active workforce also seemed to militate against Germany's capacity to move into the newer service industries. Many observers, especially those who looked to the U.S. internet boom in the late 1990s, argued that new service enterprises relied on a very different kind of employment relations than did Germany's core manufacturing firms. Instead of customary or "normal" fulltime employment ("Normalarbeitsverhältnisse), younger service firms seemed to require lower wages with fewer specific skills and less permanent or full-time work schedules. These were precisely the conditions that tended to give aspiring entrants – the young, the less skilled, and, above all, women – an avenue into the workforce. Unsurprisingly, parties across the political spectrum began to sing the praises of smaller, more flexible enterprises, and to seek ways of promoting their formation.

The first priority of the Red-Green coalition 1998 was to find a solution to Germany's employment crisis. This goal entailed somehow overcoming the insider-outsider divide that largely restricted political voice to those interests that had benefited most from the institutional arrangements built up over the preceding five decades. Under Gerhard Schroeder's direct leadership, the new government first tried to open up Germany's labor markets by convening unions and employer associations in tripartite

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<sup>25</sup> Ibid.

talks to create a new low-wage employment sector that would allow for part time employment. This effort at direct negotiation soon foundered, showing that the state had lost its earlier potential for bringing peak-level bargaining between the social partners to a successful outcome. The new coalition did not, however, abandon its efforts to open Germany's economic arrangements more open. Instead it used tax policy and codetermination laws to alter the composition of the social partners themselves. The policy histories delineated in the next section show how these efforts at tax reform and the revision of codetermination requirements created possibilities for new and shifting preferences within the organized social interest groups. These policy measures embodied an effort at "second-order change" -- not always fully articulated but nonetheless identifiable -- that would lead the social partners away from their usual strategy of protecting "insiders" in privileged manufacturing sectors and instead move them toward greater inclusion of the relative outsiders in the newer service industries.

### III. ATTEMPTED REFORMS

#### A. *Failed Concertation: The 'Alliance for Jobs'*

The Red-Green coalition entered government with a clear mandate to open Germany's labor markets, but it was unclear whether it could overcome resistance to such reforms by unions and employers' associations. Schroeder's government formed a new extra-

parliamentary peak forum, known as the Alliance for Jobs, that convened employers and unions with the hope of introducing measures akin to the widely-admired Dutch reforms through tripartite concertation. The insulation of industrial relations from state intervention, however, circumscribed the capacity of the German government to coordinate corporatist cooperation. Without such leverage, Red-Green efforts to reform labor markets stalled against the opposition of employers' organizations and the unions. This section reconstructs Red-Green reform intentions and employer and union resistance to them in the Alliance for Jobs.

Efforts to boost employment by changing labor markets began immediately after the new government took office in 1998. The first step was to re-energize tri-partite negotiations -- originally an initiative of IG Metall President, Klaus Zwickel – which had become moribund in the first incarnation of the Alliance for Jobs under the government of Helmut Kohl. The new Alliance had a permanent structure modeled after the Dutch “Social and Economic Council,” with parity representation of government, labor, and employers.<sup>26</sup> The Alliance’s initial declaration on December 7, 1998, committed the state, unions, and business to “lasting cooperation” in overcoming high unemployment, “the greatest challenge to politics and society at the turn of the century.”<sup>27</sup> Along with other goals, the declaration stated the intention of the Alliance to combat unemployment through “the creation of new areas of employment and training opportunities for less-

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<sup>26</sup> “Das Bündnis für Arbeit wird Dauereinrichtung mit großem Apparat,” *Frankfurter Allgemeine Zeitung* [hereafter *FAZ*], 24.2.1999.

<sup>27</sup> “Gemeinsame Erklärung des Bündnisses für Arbeit, Ausbildung, und Wettbewerbsfähigkeit zu den Ergebnissen des 1. Spitzengesprächs am 7. Dezember 1998 at [http://www.bundesregierung.de/dokumente/Schwerpunkte/Buendnis\\_fuer\\_.../ix7328\\_56651.ht](http://www.bundesregierung.de/dokumente/Schwerpunkte/Buendnis_fuer_.../ix7328_56651.ht) visited June 28, 2002.

qualified employees.”<sup>28</sup> Representatives of the Alliance’s peak-level partners established working groups to formulate specific proposals for achieving its goals.

In its so-called “Benchmarking Group,” Alliance members commissioned a panel of experts to evaluate the applicability of labor market practices in other countries to the situation in Germany.<sup>29</sup> They found that the success of Dutch governments in increasing employment in low-skill/low-wage service sectors industries provided a useful example for German policy-makers. Members of the panel also agreed that increasing employment in the service industries would require improving the conditions of doing business in this sector, especially for new firms. Here also Dutch policies seemed to offer a promising example. Service industries were thought to be both labor-intensive and less-productive. These attributes made the demand for employees highly elastic with regard to the price of labor. Dutch policymakers had succeeded in boosting service-sector employment by reducing the non-wage, labor costs that went to payroll contributions for social insurance. Following the Dutch lead, the experts of the Benchmarking group proposed to use tax revenues to subsidize contributions to social programs for employees in low-wage sectors. They argued that subsidizing non-wage labor costs in the lower wage service industries would reduce the number of individuals drawing social transfers, limit the cost of such programs, and thereby reduce the cost of new jobs in a dynamic, job-creating circle.

The Benchmarking Group experts accordingly introduced proposals to benefit labor market “outsiders,” but they needed the support of “insiders” representatives in

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<sup>28</sup> Ibid.

<sup>29</sup> Gemeinsame Erklärung des Bündnisses Für Arbeit, Ausbildung und Wettbewerbsfähigkeit zu den Ergebnissen des 3. Spitzengesprächs am 6. Juli 1999 at [http://www.bundesregierung.de/top/sonstige/Schwerpunkte/Buendnis\\_fuer\\_Arbeit/ix7274\\_.htm](http://www.bundesregierung.de/top/sonstige/Schwerpunkte/Buendnis_fuer_Arbeit/ix7274_.htm), visited July 31, 2002.

labor and employer associations to get their proposals put into action. Employers and unions had already shown that they were prepared to block reform initiatives when asked to bear the costs of assisting individuals and organizations outside their ranks. After the Red-Green government made good on campaign promises to revoke the Kohl government's symbolic liberalization of hiring and firing, the employers quickly made it clear that they expected wage restraint from the unions in return for these restrictions on managerial flexibility. With encouragement from the Chancellor's office, the employers introduced wage guidelines to the Alliance's agenda for discussion.<sup>30</sup> Union leaders, led by IG Metall's Klaus Zwickel, quickly invoked the constitutional principle of wage autonomy (Tarifautonomie) and refused to discuss wages within the Alliance framework. Employers and unions both appeared reluctant to bear the cost of labor market reforms that would benefit them only indirectly, and the principle of wage autonomy enabled them to veto government efforts that allocated the costs of reform in ways they considered too disadvantageous.

The state's semi-sovereign powers in regard to the organized social partners in Germany differed clearly from the Dutch conditions that specialists in the Alliance's Benchmarking Group used as the backdrop for their reform proposals. Dutch efforts to increase unemployment succeeded because the social partners there had accepted -- or were obliged to accept -- asynchronous payoffs.<sup>31</sup> Under the threat of government intervention, Dutch employers and unions accepted work time limits and wage restraint

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<sup>30</sup> "Der unsichtbare Dritte," in *Der Spiegel* 8/1999 (22 February), pp.92-92.

<sup>31</sup> "Bündnis ohne Konzept: Interview mit Jelle Visser," in Theo Pischke, "Malefiz am Bündnis-Tisch," in *Die Woche* May 28, 1999; Jonah D. Levy, "Vice into Virtue? Progressive Politics and Welfare Reform in Continental Europe," in *Politics and Society* 27/2 (June 1999), p.259; Tobias Schulze-Cleven, "Social Democratic Rule, Corporatist Arrangements and Progressive Welfare State Reform in Continental Europe," unpublished Master's Essay, Department of Political Science, University of California, Berkeley (Spring Semester 2002).

in the 1980s as firms undertook the restructuring that increased employment and made rising incomes possible in the 1990s.<sup>32</sup> Germany's constitutional protection of wage autonomy made it impossible for the German state to impose the immediate burden of reform on German employers and unions in return for future payoffs.

Much of the disagreement over the Benchmarking Group's proposals concerned specific measures for financing. The Greens in parliament highlighted their environmental priorities by suggesting a new "Eco-Tax" that they said would make new revenues available to subsidize non-wage labor costs throughout the economy. The Benchmarking Group's expert panel believed they could maximize the creation of entry-level jobs by focusing government subsidies on social contributions for employees in the lowest paying sectors.<sup>33</sup> They suggested a digressive schedule of subsidies in which tax revenues covered the full amount of employer and employee contributions to social programs below a certain wage level (DM1500), but then declined to zero at higher wages (DM2800).<sup>34</sup> The experts pointed out that this proposal would not reduce the overall size of social programs, but it would redistribute resources "from high to low incomes, from industry to the services, from large to small enterprises, from pensioners to active employees..."<sup>35</sup> These proposals clearly aimed at supporting labor-market "outsiders" without giving much to the "insiders" in Germany's core manufacturing industries. In effect, the government became advocate for the outsider interests in a special negotiating forum that it had established expressly to convene the traditional

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<sup>32</sup> Ibid.

<sup>33</sup> The "Ecological Tax" [*Ökosteuer*] used tax revenues to subsidize contributions to social programs equally at all wage levels. See Simon Lightfoot and David Luckin, "Research Note: The 1999 Ecological Tax Reform Law," *German Politics*, 9:1 (April 2000): 139-144.

<sup>34</sup> The figures given are the preliminary suggestions of the Benchmarking Group. See

<sup>35</sup> Fels, Gerhard, Rolf G. Heinze, Heide Pfarr, and Wolfgang Streeck, *Bericht der Wissenschaftlergruppe der Arbeitsgruppe Benchmarking über Möglichkeiten zur Verbesserung der Beschäftigungschancen gering qualifizierter Arbeitnehmer* (Online-Version), November 1999.

insider interests that dominated the politics of social policy in Germany. This constellation did not bode well for the kind of extra-parliamentary consensus that the new Chancellor envisioned.

The first reports of the Benchmarking Group's proposal surfaced in mid-March 1999, shortly after Oskar Lafontaine's dramatic resignation as Finance Minister and SPD Party Chairman.<sup>36</sup> A few months later, on May 10<sup>th</sup>, the news magazine Der Spiegel published an edited version of the Benchmarking Group's report under the authorship of Wolfgang Streeck and Rolf Heinze.<sup>37</sup> DGB leaders -- who had publicly criticized the cost of the Benchmarking Group's proposal a few days earlier<sup>38</sup> -- used the "leak" of the report as grounds to refuse discussion of it at a meeting in the Chancellor's office scheduled for that purpose.<sup>39</sup> The umbrella organization of German employers' associations, the BDA, signaled similar displeasure with the report.<sup>40</sup>

In their more detailed reactions to the proposals, unions and employers both objected to particular features of the tax-based financing. The metalworkers' union, IG Metall, vehemently opposed the use of general tax revenues in a position paper published shortly after the report in Der Spiegel.<sup>41</sup> According to the union, the subsidies would move social programs out of a payroll-based system, which employers and employees shouldered equally, to a tax-based system that relieved employers of any direct responsibility for social policy.<sup>42</sup> The union would only consider proposals that funded

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<sup>36</sup> "Freie Hand für den Kanzler," *Der Spiegel* 11/1999 (March 15, 1999), pp.22-35

<sup>37</sup> "An Arbeit fehlt es nicht," *Der Spiegel* 19/1999 (May 10, 1999), pp.38-45.

<sup>38</sup> "Blockade gegen Billigjobs," in *Der Spiegel* 20/1999 (May 17, 1999), p.60.

<sup>39</sup> "DGB schlägt Krach im Bündnis für Arbeit, Verärgerung über vorzeitig veröffentlichte Studie" *Sueddeutsche Zeitung* [hereafter *SZ*] May 11, 1999, p.1.

<sup>40</sup> *Ibid.*

<sup>41</sup> IG Metall, *Stellungnahme zum Zwischenbericht der Arbeitsgruppe "Benchmarking,"* 19.5.1999, available at <http://www.igmetall.de/buendnis/niedriglohn.html> visited July 31, 2002.

<sup>42</sup> *Ibid.*

subsidies through new sources of parity-based revenue that employers shared with employees on an equal basis.<sup>43</sup> Employers, however, had already rejected increasing overall taxation to subsidize new programs.<sup>44</sup>

Although the Alliance for Jobs enjoyed high visibility as a structured round of talks convened at the highest level of the executive branch, the social partners found it quite easy to find other allies in the coalition parties when they sought to block particular proposals. The advisors to the Benchmarking Group served at the pleasure of the Chancellor and the Chancellory Minister, Bodo Hombach, who also chaired formal meetings of the Alliance. The Benchmarking proposals for tax-based subsidies appeared to conflict directly with efforts of the Labor Minister, Walter Riester, whose staff had just introduced legislation to preserve the principle of parity-based payroll contributions on any new part-time jobs that paid less DM 630 per month. The strict fiscal discipline favored by Hans Eichel, the successor to Oskar Lafontaine in the Finance Ministry, gave further ammunition to those who opposed the costs of the subsidy program. Opposition to subsidies became insurmountable when two reports projected the program's cost in excess of DM30 billion and unions, employers and members of the coalition balked at raiding existing labor market programs to pay for it.<sup>45</sup> Against this resistance, Hombach retreated tactically behind the formulation that, "any model that rests on drawing new funds from the federal budget does not fit in the present fiscal situation."<sup>46</sup> At the time, resistance to the program's cost ensured that the Benchmarking Group's proposals

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<sup>43</sup> Ibid.

<sup>44</sup> "Arbeitgeber: 630-Mark-Gestz stoppen," *taz* 18.5.1999.

<sup>45</sup> Theo Pischke, "Malefiz am Bündnis-Tisch," in *Die Woche* May 28, 1999.

<sup>46</sup> "Streit über die Ausweitung des Niedriglohnsektors" *AP Worldstream – German*, 11.5.1999.



remained confined to a number of regional pilot programs.<sup>47</sup> With Hombach's resignation as Chancellory Minister in July 1999 -- for unrelated reasons -- the proposal to subsidize social contributions for low-wage jobs disappeared from the Alliance's agenda.<sup>48</sup>

The fate of the Benchmarking Group's proposals showed how difficult it was for the Red-Green government to use the customary strategy of tripartite negotiations with the social partners as a means of making Germany's labor markets more hospitable to part-time or lower wage jobs. In this sense, the rejection of the Benchmarking Group's proposals closely resembled the pattern of "blocked" reform that quickly became a general label for the new government's efforts to restructure Germany's economic institutions. Within a year or two, meetings of the Alliance for Jobs became almost perfunctory. As one former participant in the expert advisory group noted retrospectively, without mustering more ability to discipline both unions and employers, the Schroeder government could do little to enforce the kinds of package deals that had made earlier examples of tri-partite concertation more successful.<sup>49</sup> The coalition's subsequent efforts to change Germany's economic institutions followed a pattern of bilateral negotiations with either labor or employers separately, but not both at the same time. While these bilateral discussions have provided little evidence of revitalizing deliberate social partnership, they have introduced significant openings for change in other ways. Rather than confronting or disciplining the social partners directly, the Red-

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<sup>47</sup> Theo Pischke, "Malefiz am Bündnis-Tisch," in *Die Woche* May 28, 1999.

<sup>48</sup> One observer at the time prophesized that the idea of subsidies would not remain dormant for long, and, indeed, they have resurfaced in the proposals of the Hartz Commission in Summer 2002. See Horst Siebert in Theo Pischke, "Plan mit Tücken," in *Die Woche*, 21.5.1999, p.13; and

<sup>49</sup> Wolfgang Streeck and Anke Hassel, "The Crumbling Pillars of Social Partnership," *West European Politics* 26:4 (October 2003): 101-124.

Green government opted for legislation that started a process of changing the composition and the preferences of the social partners themselves.

*B. 'Second Order' Change: Tax Reform*

If efforts to alter German labor markets foundered on the opposition of unions and employers' associations in the first four years of the Red-Green coalition, "blockade" was not the only outcome the new government secured. If anything, the failure of the Alliance for Jobs shifted reform in a different direction. By invoking constitutional guarantees of their right to negotiate without binding government supervision, the unions and employers had signaled their firm intention to oppose any efforts at diluting their privileged positions in the policy process or the economy. As if by default, the Red Green coalition quickly turned toward initiatives that would indirectly alter the make-up of German interest groups and, thereby, invite longer-term changes in their preferences. This shift in strategies for institutional change appeared most quickly in the government's proposals for tax policy and for renewing the laws on codetermination. The changes in tax policy increased the availability of capital for the small and medium-sized firms in Germany's Mittelstand, while shifting a portion of the tax burden away from them toward large industrial enterprises. Revision of Germany's co-determination laws meanwhile created an incentive for unions to court employees in service sector firms. By facilitating the formation of works councils in smaller firms, the Red-Green initiative motivated the unions to organize workers in the smaller service-sector firms that had customarily

figured lower on their list of priorities. The following two sections analyze changes in both areas.

Rationalization of the tax code had been a long-cherished goal of officials in the Ministry of Finance and the Ministry of Economics, but it suddenly became a priority when Hans Eichel replaced Oskar Lafontaine as Finance Minister in early 1999. Eichel appointed a private-sector tax specialist from the Bayer pharmaceutical firm as one of his deputy ministers and quickly moved toward a comprehensive review of company and individual taxation.

With the “Law to Sink Tax Rates and Reform Enterprise Taxation,” the Red-Green government dramatically changed the constraints imposed by the tax code on corporate organization in Germany.<sup>50</sup> The 2000 overhaul of the tax system rationalized the structure of personal and corporate income taxes, while also providing some relief to business. The new legislation produced two consequences that favored small and medium sized firms, particularly in the services. First, it reduced to zero the tax rate on capital gains realized by one firm through the sale of equity in another. This change benefited large financial firms handsomely but also permitted capital trapped in the equity of large industrial enterprises to move toward newer and smaller firms. Second, reform shifted the tax burden away from small businesses toward large industries by reducing corporate income taxes and depreciation allowances simultaneously. The following examines changes in the taxation of capital gains and the distribution of the corporate tax burden.

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<sup>50</sup> Johannes Müller-Dott, “Die geplante Steuerreform verändert das unternehmerische Handeln,” in *FAZ* May 22, 2000, *Wirtschaft* p.29.

The elimination of taxes on capital gains (Veräußerungsgewinne) amounted to a major sea-change in the institutions for financing industry in Germany. The maintenance of long-term equity stakes in industrial companies was one of the distinctive features in the large banks' ability to supply "patient" capital and coordinate the country's industrial development over a long-term horizon.<sup>51</sup> Perhaps for exactly this reason, the Finance Ministry submerged this aspect of the legislation in a much broader tax package that was announced over the Christmas holiday in December 1999.<sup>52</sup> Even during the drafting of the legislation, change in capital-gains treatment received less discussion than did changes in corporate and individual income tax. According to some participants in the Ministries, the New York brokerage houses got wind of the potential sea-change before the German press publicized it. As the scope of the legislation became known, however, the large banks and financial firms quickly acknowledged its potential for unwinding the close networks that had historically dominated the world of industrial finance in Germany.<sup>53</sup>

By eliminating the tax on capital gains from corporate sales of equities, legislators removed in a single stroke a major hurdle that had prevented banks and insurance companies from divesting equity stakes they had held in Germany's largest industrial enterprises, sometimes for decades. The prior capital gains taxes had constituted a major barrier to such sales. As the head of the Allianz insurance group calculated, his firm had

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<sup>51</sup> This is the classic view of Germany's universal banks as traced by Gerschenkron and described by Andrew Shonfield in the 1960s.

<sup>52</sup> Another motivation for scheduling the announcement during the Christmas holiday may have been to avoid potential criticism from within the SPD. See for example Wolfgang Reuter, Michael Sauga, and Ulrich Schäfer, "Eichels Revolution" in *Der Spiegel* 2000/1 (January 3), pp.22-5 and Theo Pischke, "Steuer-Coup" in *Die Woche* January 7, 2000. Edmund L. Andrews, "Germany Proposes Some Tax-Free Stock Sales, Lifting Market," in *New York Times* [hereafter *NYT*] December 24, 1999, C1:2.

<sup>53</sup> Interview, Economics Ministry official, June 2004, Berlin.

under the prior system paid 58% of realized capital gains to tax authorities.<sup>54</sup> Removal of this impediment would permit firms to unload cross-holdings of each other's shares, unravel the interlocking management structures that made German business impervious to outside influence, and set off a wave of merger and acquisitions. In short, observers predicted that the proposed changes to capital gains taxation portended the defeat of "Germany Inc." and the subjugation of German managers to a market for corporate control oriented toward "shareholder value."<sup>55</sup>

Regardless of whether elimination of corporate capital gains taxes signaled the end of "Germany Inc.," the change created financial advantages for new and smaller firms. Even if banks and insurance companies retained some of their cross-holdings as "strategic positions," these holdings were sure to become smaller. Estimates of hidden reserves in the German financial sector ran between 250 and 270 billion Euros.<sup>56</sup> In the months after announcement of the change in capital gains taxation, several large banks and insurers announced they were beginning to divest large portions of these holdings, potentially freeing up many billions of Euros of investment capital.<sup>57</sup> The tax reform drastically reduced the banks' costs of liquidating under-performing investments and re-allocating resources to ventures yielding higher returns. Financial markets regarded this as the immediate outcome of reform, bidding up the shares of Allianz, Munich Reinsurance, Deutsche and Dresdner Bank by 10%-20% in the session after the changes

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<sup>54</sup> "Eichels Revolution," p.24.

<sup>55</sup> Other observers argued that Germany's system of interlocking directorates would survive these changes as they were held in place by other structures and large banks and insurance companies had signaled they would retain "strategic positions" in each others' companies and important industries. See Hermanns Pfeiffer, "Unsinnige Hoffnung" in *taz* February 12, 2000, p.8.

<sup>56</sup> Bertrand Benoit, Jeremy Grant, Haig Simonian, "German Companies Take Time to Study Tax-Cut Measures," in *Financial Times* [hereafter *FT*] September 5, 2000, p.36; and Tony Barber, "Survey – German Banking, Finance and Investment: A Cure for the 'German Disease:,' Cross-Shareholdings," in *FT*, October 23, 2000.

<sup>57</sup> *Ibid.*

were announced.<sup>58</sup> Clearly firms in the financial services benefited first and foremost from the reform. At the same time, however, the abolition company capital-gains taxation deepened capital markets and facilitated the flow of investment capital to newer sectors and firms. By doing so, financial market reforms held the potential to alter labor markets by increasing employment in new economic sectors.

Increasing service sector employment was clearly on the minds of Red-Green policy makers who introduced changes in capital gains regulation to the tax reform. A year earlier, in December 1998, the Alliance for Jobs called for “improved access of small and medium-sized enterprises to risk capital [*Chancekapital*]” and placed tax policy on the Alliance agenda.<sup>59</sup> Further, the Finance Ministry empanelled an expert commission to consider reform of business taxes with the goal of creating employment in middle-sized firms.<sup>60</sup> In presenting its draft legislation for public scrutiny in December 1999, the Finance Ministry described the tax reform as an “important impulse for modernization and restructuring of the economy.”<sup>61</sup> Finance Minister Hans Eichel lauded the reform as a step toward “creation of a different equity culture in Germany.”<sup>62</sup> He also predicted that capital, stranded in banks for years, would boost the economy by flowing into enterprises that could make productive use of it.<sup>63</sup> Finally, he suggested the government had done its part and now it was time for movement by the other partners in the Alliance for Work.<sup>64</sup> After the failures in the Alliance for Work, Red-Green policy

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<sup>58</sup> Edmund L. Andrews, Op. cit.

<sup>59</sup> “Gemeinsame Erklärung...8. Dezember 1998.”

<sup>60</sup> Kommission zur Reform der Unternehmenbesteuerung, “Brühler Empfehlungen zur Reform der Unternehmensbesteuerung,” Brühl 30. April 1999, found at <http://www.weltrecht.de/national/texte/bruehlerempfehlungen.htm> visited August 5, 2002.

<sup>61</sup> dpa-Europadienst, December 23, 1999.

<sup>62</sup> “Eichel ermuntert die Wirtschaft,” in AP Worldstream-German, January 2, 2000

<sup>63</sup> Ibid.

<sup>64</sup> Ibid.

makers intended tax reform to trigger reorganization of German business and growth in those sectors that remained underdeveloped in the German economy.

This grand design might have provoked intense resistance, but opposition failed to materialize for several reasons. Most importantly, the government embedded its effort to shift the composition of German industry in a larger tax bill that rewarded many constituencies and penalized only a few. The reform lowered tax rates on private and corporate incomes across the board. Private individuals received the bulk of the savings, or about DM 57 billion of a total of DM 76 billion by 2005.<sup>65</sup> Banks and other financial institutions certainly raised no objections to elimination of corporate capital gains. And, where resistance began to coalesce, the government responded quickly. When fund managers and the representatives of small investors complained that the reform discriminated against them, the government extended preferable treatment to capital gains in investment funds as well.<sup>66</sup> Similarly, the coalition diffused criticism from the craft workers' lobby, that the tax reform benefited the rich at the expense of the humble, by raising the limit on the tax-free sale of firms from DM60,000 to DM100,000.<sup>67</sup> Through such measures, the Red-Green government thoroughly outflanked the opposition and built strong business support for the tax reform. In an unintentional admission of the opposition's failure, Bavarian Minister President and CSU Chairman, Edmund Stoiber, accused the SPD of having become the "Party of Big Capital."<sup>68</sup> At the same time, Friedrich Merz, chairman of the CDU Parliamentary Group, criticized leaders of

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<sup>65</sup> "Die rot-grüne Steuerreform in der Übersicht," in AP Worldstream-German, May 18, 2000.

<sup>66</sup> "Grüne: Keine Körperschaftssteuer für Investmentfonds," in AP Worldstream-German January 26, 2000.

<sup>67</sup> "Grüne diskutieren Nachbesserungen bei der Steuerreform," in AP Worldstream-German February 19, 2000.

<sup>68</sup> "Union will 50 Milliarden Nettoentlastung ohne Gegenfinanzierung," in AP Worldstream-German, January 8, 2000.

Germany's most important associations for large as well as small and medium-sized industries, the BDI and DIHT, for supporting the tax reform.<sup>69</sup> The tax reform succeeded because it received support not only from constituencies close to the coalition, but also because it rewarded large sections of the German business community.

The 2000 tax reform did, however, produce “losers” as well as “winners” in German business. In cutting taxes, the government operated within narrow fiscal constraints. Rulings handed down by the courts and the stability criteria imposed by European Monetary Union had already cut federal revenues and limited new debt. The government cut corporate taxes on large and small enterprises alike, but—determined to avoid new debt—it neutralized much of the fiscal effect of this cut by changing the rules on capital depreciation. Indeed, while reduction of taxes on enterprise incomes projected savings of DM32.5 billion for firms, the government calculated net enterprise savings would be only DM8.3 billion.<sup>70</sup> Tighter regulation of capital depreciation makes up the bulk of the difference between these two figures. The government recovered DM13 billion in lost revenues by reducing the depreciation allowance on mobile capital assets from 30% to 20% and another DM0.54 billion by reducing the depreciation rate on enterprise buildings from 4% to 3%.<sup>71</sup> An additional DM3.4 billion in revenues was to come from lengthening depreciation schedules.<sup>72</sup> In evaluating the effects of the tax law on different sectors, the investment bank ABN Amro placed small and consumer-oriented businesses, as well as large financial institutions, among the reform's “winners.”<sup>73</sup> The

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<sup>69</sup> “Fronten im Steuerstreit verhärtet,” in AP Worldstream-German, March 22, 2000.

<sup>70</sup> “Die geplante Steuerreform der deutschen Regierung,” in dpa-Europadienst, December 21, 1999.

<sup>71</sup> Bundesverband Deutschen Industrie (BDI) e.V., “Die geplante Reform der Unternehmenbesteuerung im Überblick,” in *Aktuelle Steuerrundschau* 2000/1 (March 3), p.2.

<sup>72</sup> Ibid.

<sup>73</sup> “Analysten Einschätzungen aus dem dpa-AFX Nachrichtendienst,” in *AFX – TD*, December 23, 1999.



same report predicted that changes in depreciation rules would fall most heavily on the machine tool and transportation sectors.<sup>74</sup> In effect, the Red-Green tax reform provided small and medium-sized firms significant tax relief at the expense of larger producers, especially in Germany's exporting industries.<sup>75</sup>

Through its multiple effects, the Red Green tax legislation addressed the need to open German labor markets in a second, less direct route. If the attempt to open a low wage sector directly, through subsidization of non-wage costs, failed, tax reform presented an opportunity to accomplish a similar goal indirectly. The abolition of corporate capital gains created a mechanism to move existing reserves of hidden capital from banks and industrial enterprises to newer sectors with higher returns on investment. In addition, a general reduction in tax rates created an inducement for firms to enter the consumer service sector in terms of both demand and supply. Cuts in personal income taxes increased disposable income and demand among consumers. At the same time, the government's measures for recouping lost revenues, particularly through the shrinking of depreciation allowances, fell primarily on manufacturing firms and left the reduction in enterprise taxes on service firms untouched, thereby giving a substantial asymmetric assist to the service sectors. Much of the public reaction to the tax reform focused on the benefits it provided to large banks and insurers. Paradoxically, the outcry over windfall profits to the financial service firms distracted attention from the very significant tax relief given to small and medium-sized enterprises, mostly at the expense of the larger concerns in Germany's traditional export sectors.

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<sup>74</sup> Ibid.

<sup>75</sup> The head of the BDI's tax division, Hans-Jürgen Müller-Seils, shares this evaluation. See "Comment & Analysis: Germany Unbound," in *FT* August 10, 2000, p.14.

In effect, the 2000 Tax Reform package provided both mechanism and inducement to draw investment into the same sectors of the economy that the Benchmarking Group of the Alliance for Work had tried to promote by subsidizing social contributions. Where it had failed to induce employers as a group to move into low-wage sectors, the Red-Green government created real incentives for firms to enter these sectors on their own. If the new coalition pushed investors and employers to enter such new sectors, the next section shows how the coalition also pressure unions to organize lower-wage employees in the same kind of expanding economic activities.

*C. 'Second Order' Change: The 2001 Revision of the Works Constitution Law*

While the 2000 tax reforms created incentives to draw investment and employment into low-wage service sectors, with the 2001 reform of the Works Council Law [*Betriebsverfassungsgesetz*, hereafter BVG] the Red-Green government sought to shape labor relations in this part of the economy. This choice took place against a backdrop in which structural change in the German economy offered an opportunity for a departure from the “negotiated” organization of German labor markets. Legislation on taxes and codetermination might have hastened existing developments toward a more pluralist organization of the economy. And, indeed, voices within the political system, and even within the Red-Green coalition, advocated legislative intervention to undermine the control of producers’, employers’, and union organizations over their members.<sup>76</sup> The

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<sup>76</sup> For example, the FDP supported changing Article 77 Paragraph 3 of the BVG that maintained a strict division of labor between works councils and unions. Some Green politicians sought to legislate changes in

Red-Green reform of the BVG demonstrates a rejection of neo-liberalism in favor of an effort to adapt the existing structure of codetermination and labor relations to meet the challenges that faced the German economy. This effort represents reform rather than blockade. It seeks not to straightjacket firm-level developments within a fixed set of institutions, but to preserve the “negotiated” character of labor relations while adapting the institutions of industrial to the forces of change. While the reform preserves a familiar organization of labor relations, it lays the groundwork for gradual but ongoing change in the processes of labor representation in Germany.

The same changes that exerted pressure on Germany’s labor markets and tax code were also beginning to prompt change in the way German companies organized their internal workings. New conditions of competition and technology that challenged the centralized organization of many German firms included shorter product cycles, more turbulent market conditions, increasing cost pressures in high-quality market segments, a shift away from incremental to more discontinuous innovation strategies, the spread of equity markets, and steadily increasing unemployment.<sup>77</sup> As firms responded to these new conditions, often by decentralizing their operations, they destabilized the foundation that made the codetermination rights of employee representatives central to company decision-making. Management decisions to distribute activities to small sub-contractors or to grant operating units greater autonomy, for example, increasingly frequently

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the so-called “concession principle” [*Begünstigungsprinzip*] in the BVG that permitted firms and works councils to depart from umbrella wage agreements only if these departures provided greater concessions to employees on the part of employers. Interview, Green party parliamentarian, Berlin, June 2003. A number of the Greens’ parliamentary leaders were sympathetic to reforms that reduced the decision-making power of unions and producer organizations vis-à-vis their members such as the economic chambers. See Bündnis 90/Die Grünen Bundestagsfraktion, “Initiative für Investitionen, Arbeit und Umwelt,” in *In der DEBATTE* (March 23, 1999) 16/99 ( Bonn)

<sup>77</sup> Kommission Mitbestimmung, Mitbestimmung und neue Unternehmenskulturen – Bilanz und Perspektiven (Gütersloh: Verlag Bertelsmann Stiftung, 1998).

eliminated jobs covered by employee representation. Such developments tended to create new operating units without works councils or move work to independent units – often a “self-employed” subcontractor -- with little or no voice in the decision-making of the larger firms. As a result, the number of workers covered by different types of codetermination in Germany’s private-sector economy declined precipitously in the 1980s and 1990s.<sup>78</sup>

In 1998, a commission of managers, academics, and representatives from employers’ and union organizations, sponsored by the Bertelsmann and Hans Böckler Foundations, offered its evaluation of these developments and the role of codetermination in the German economy. The Commission on Codetermination’s [Kommission Mitbestimmung] report offered unanimous praise for codetermination’s contribution to German competitiveness.<sup>79</sup> It also recognized that the successes of codetermination are inextricably linked to the system of labor relations built around the “wage autonomy” of unions and employer organizations. The report concluded that the reorganization of enterprises and work in response to conditions on world markets had opened an expanding “codetermination-free zone” in the private sector.<sup>80</sup> It also argued that codetermination provided a particularly useful, and socially responsible, mechanism with which enterprises had managed to adjust to the evolving economic environment. While the Commission’s members agreed that structural changes were undermining an economically and socially useful structure, they could not agree about how to respond to the institutional erosion of codetermination.<sup>81</sup>

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<sup>78</sup> Ibid., Chapter 4.

<sup>79</sup> Ibid., Vorwort and Dagmar Deckstein, “Netze statt Gesetze,” in SZ October 7, 2000, p.25.

<sup>80</sup> Ibid., Chapter 1, #10ff.

<sup>81</sup> Ibid., *Vorwort*.

Disagreement within the expert commission showed that any revision of plant-level codetermination necessarily touched not only on relations between employers and employees in the firm, but also on the (vertical) links between firm-level actors and the more aggregate employer associations and the nation-wide industrial unions. One of the key virtues of Germany's codetermination rules was that they permitted firm-level actors substantial latitude to tailor sectoral labor contracts to local needs as firms responded to changing market conditions.<sup>82</sup> The Commission on Codetermination reported that most of the innovations in codetermination practice that would facilitate firm adaptation must necessarily take place at the local level as contractual agreements between employer and employee representatives rather than as state legislation.<sup>83</sup> Those developments that moved decision-making capacity from sectoral collective bargaining to the firm level strengthened firm-level actors at the expense of the superordinate actors, and, in particular, strengthened works councils at the expense of unions. Not surprisingly, the union leaders eyed such developments with suspicion. At the same time, according to the Commission, employees were only able to participate in firm-level experimentation if a minimum set of employees rights – a kind of legal safety net – was guaranteed by law. The reorganization occurring in many enterprise was, however, undermining precisely these guarantees by moving production activities into the codetermination-free zone.

While innovations in codetermination were likely to evolve out of contractual agreements, the Commission therefore argued, state action was necessary to “protect and reinvigorate” the legal framework that sustained such innovation.<sup>84</sup> Accordingly, the

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<sup>82</sup> Kathleen Thelen, *Union of Parts* (Ithaca: Cornell University Press, 1991).

<sup>83</sup> Kommission Mitbestimmung, *Op cit.*, “Empfehlungen zur zukünftigen Gestaltung der Mitbestimmung,” #8-10 and Chapter 2.

<sup>84</sup> *Ibid.* Chapter 3 #29.

Commission's report suggested state action to revise the legal definition of the terms "concern," "firm," "enterprise," and "employee" and guarantee employee representation in small and medium-sized firms.<sup>85</sup> Such legislation would not only strengthen works councils, but, through them, unions as well. Many employers found this result objectionable. Any effort to manage the adaptation of codetermination rules would shift the balance of power between firm-level actors, employers' organizations, and unions, and this potential created interest conflicts of interest in the Commission as in German society more generally.

These divisions presented the Red-Green government with a number of alternative approaches to the renewal of the firm-level law on codetermination. Inaction would permit codetermination to continue to exist in larger, exporting firms where employers and employees shared an interest in its survival, while the "codetermination-free zone" grew among small and medium sized firms. This position satisfied employers' associations and business groups, which were split between their larger members' interests in maintaining codetermination and their smaller members' objection to its extension to their firms. Alternatively, economic liberals outside the coalition – as well as a few of the market oriented Greens within the coalition – argued for state action to limit the use of umbrella contracts and patterned wage bargaining in order to promote greater labor market "flexibility." This approach would have meant either revising Article 77 Paragraph 3 of the BVG and (which maintained the unions' monopoly on representing employees in wage negotiations) or eliminating the "concession principle" (*Begünstigungsprinzip*)<sup>86</sup> and thereby allowing firms to depart from umbrella contracts

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<sup>85</sup> Ibid.

<sup>86</sup> See note 64 above.

even when so doing served management more than the workforce. Finally, the government could heed the conclusions of the Commission that codetermination – and the system of industrial relations of which it was a part – supplied an appropriate means for managing firm-level adjustment to turbulent market conditions. This approach would require legislative steps to reinvigorate worker representation where it existed and to extend it where economic conditions had precluded or undermined its operation. The coalition agreement of 1998 remained ambiguous about which of the courses of action the new government would pursue. It committed the new government only to renew the BVG so as to strengthen the position of actors within enterprises and to adapt codetermination to changing environmental circumstances.<sup>87</sup>

The unions sought to push the Red-Green government toward strengthening the inherited provisions for codetermination and industrial relations. Leaders of the DGB fought the tendency of some Green politicians to include unions among the established concentrations of economic power to be unraveled. After concerted tussling with labor leaders, the Green parliamentary leaders agreed that BVG, Article 77, Paragraph 3 would remain intact along with the union monopoly in contract negotiations.<sup>88</sup> In addition, union leaders overcame the government's reluctance to antagonize business groups by reinforcing or extending the scope of worker representation at the plant level. The peak business associations, including both the BDA and DIHT, followed their small and medium-sized members by protesting legislative drafts that strengthened the definition of an "enterprise" and an "employee," or that eased construction of works councils in

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<sup>87</sup> *Aufbruch und Erneuerung – Deutschlands Weg ins 21. Jahrhundert* reprinted in SZ October 21, 1998.

<sup>88</sup> "DGB und Bündnis 90/Die Grünen einig über Novellierungsaspekte bei der Betriebsverfassung," DGB Pressemeldung 34/2000 (February 23).

smaller enterprises.<sup>89</sup> To strengthen the government's resolve against resistance from the *Mittelstand*, union leaders threatened to hold other Red-Green reforms—particularly pension reform—hostage to their demands on codetermination.<sup>90</sup>

For leaders of organized labor, the renewal of the law on codetermination had heightened significance in the larger context of the coalition's strategies for reform. Union leaders was the retreat from parity employer/employee financing for the government's plan to create supplementary private pensions as a dangerous precedent.<sup>91</sup> Along with the advantages that tax reform had given to business, the pension reform signaled to many labor leaders that the government was moving in the direction of neoliberal reform. IG Metall President Klaus Zwickel promised the government an autumn of protests and resistance on pensions unless the government "showed the colors" and met union demands on reform of codetermination.<sup>92</sup> In September 2000, Labor Minister Walther Riester announced a reform of the BVG that "on the important points, the ones that were decisive for us," according to DGB vice chairwoman Ursula Engelen-Kefer, "nothing was watered down."<sup>93</sup> In the case of renewing the law on plant-level codetermination, union pressure clearly pushed change away from a neoliberal or deregulatory trajectory.

The changes introduced to the BVG in June 2001 thereby honored both the Commission's positive evaluation of codetermination and the unions' demand to extend

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<sup>89</sup> "Stihl: Die Wirtschaft erwartet von der Opposition Mitarbeit, keine Blockade," in FAZ July 6, 2000; Dagmar Deckstein, "Das Kriegsgeschrei der Arbeitgeber ist unglaubwürdig – SZ Interview mit Wolfgang Streck zur geplanten Reform des Betriebsverfassungsgesetzes" in SZ October 25, 2000. See also Marc Beise, "Widerstand gegen mehr Mitbestimmung," in SZ October 2, 2000.

<sup>90</sup> Michael Sauga, "Konflikt statt Konsens," in Der Spiegel 35/2000 (August 28); "SPD stimmt Rückkehr zur nettolohnbezogenen Renten bereits 2001 zu" in AFP-German September 4, 2000; "Zugeständnisse bei den Renten stossen bei Union und Gewerkschaften auf Zustimmung" in FAZ September 6, 2000.

<sup>91</sup> "Schroeder muß Farbe bekennen," in Focus Magazin 28/2000 (July 10).

<sup>92</sup> Ibid.

<sup>93</sup> Edmund L. Andrews, "Germany expands workers' councils" in *NYT* February 15, 2001, p. C5.



the scope of existing regulations. The law drafted by the Labor Ministry required employers to release a larger number of works councilors from regular work obligations and to release councilors from such obligations in smaller firms.<sup>94</sup> In order to reinforce two roles increasingly played by works councils, the revised BVG provided them with rights of initiation and consultation in efforts to secure employment and a right of codetermination in matters of training and qualification.<sup>95</sup> The legislation also addressed the changing organization of work in the economy in three ways. First, it provided new definitions for the terms “employee” and “enterprise” that extended representation to individuals who had fallen outside the purview of older regulations because of firm reorganization or a redefinition of job status. Second, new regulations permitted existing works councils in concerns or holding companies to call for election of a new works council in newly created or spun-off enterprise segments.<sup>96</sup> Finally, the reform simplified greatly procedures for electing works councils in smaller firms, particularly those with fewer than 100 employees.<sup>97</sup> In sum, the reform protected the basic elements of codetermination and largely maintained the balance of power between employers and employees within the firm as well as between firm-level actors and their superordinate counterparts.

While reform of the BVG seemed on first glance to defend the status quo, it also contained catalysts for considerable adjustment in the operation of German labor markets. As with the Red-Green government’s actions on tax policy, the renewal of the codetermination law sent a clear message that the coalition would not impede the

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<sup>94</sup> Bundesministerium für Arbeit und Soziales, “Reform der Betriebsverfassung,” in SPI 5/2001 August Beiträge.

<sup>95</sup> Ibid.

<sup>96</sup> “Betriebsräte erhalten mehr Befugnisse” in FAZ June 23, 2001.

<sup>97</sup> Ibid.

processes of structural change in the economy. Societal actors – particularly unions – therefore had to decide how the new interests created through such structural processes could be integrated into the existing organization of labor markets and the existing framework for interest representation. Reform of the BVG placed unions in a delicate position regarding the cleavage between “insiders” and “outsiders” in German labor markets. Failure to integrate employees and their firm-level representatives in emerging sectors would increase a growing constituency already alienated from existing patterns of centralized wage bargaining, perhaps hastening the transfer of representational responsibilities to the firm level. Successful integration of these interests would, however, mean a reorganization of relations between “insiders” and “outsiders” inside individual unions or through a realigned ranking in the traditional pecking order among the different unions. If anything, the renewal of the BVG strengthened a development that was already shifting primacy among the German unions. The existing *primus inter pares* in the DGB, IG Metall, had consistently failed in its attempts to attract new members among white collar employees and service industries. The amalgamated services union, Ver.di, which was formed through the merging of Germany’s white collar DAG and the service sector unions ÖTV, DPG, HBV, and GdE, was considerably larger than the metalworkers’ union. To the extent that the new provisions of the BVG amplified the relative weight of Ver.di, IG Metall stood to lose its leadership role in the negotiation of pilot contracts and the system of patterned bargaining. Any increasing independence on the part of Ver.di would signify an inclusion of former “outsiders” in German labor markets and a significant reordering of the organizations responsible for employee representation. The actions of the Red-Green government on tax reform and

codetermination did not directly accomplish this transformation, but they have clearly obliged the organized social interests to move in this direction and away from more radical alternatives to existing institutional arrangements.

#### IV. CONCLUSION

The mix of change and continuity apparent in these three policy domains reveal an underlying logic that continued to shape the politics of reform through the entire period of Red-Green government under Chancellor Gerhard Schröder from 1998 through 2005. The failure of tripartite concertation in the government's showcase effort to create jobs through the Alliance for Work led directly to a pattern of loosely linked partial reform measures. The first step occurred through the 2001 tax reform, which struck observers as a dramatic blow against Germany's institutions of "patient" or coordinated capital markets. The second step appeared through the 2001 renewal of the existing law on plant-level works councils, which clearly showed that a Red Green coalition would limit the market mechanism when it conflicted with the principle of employee voice in the economy. At first glance this record displays an inconsistent and even incoherent stance toward neo-liberal reform. On closer scrutiny, however, these policies reveal a persistent, if messy, pattern of searching for new institutions that would allow capital to move more quickly while still maintaining the legislative framework of employee rights within the workplace.

As several observers have noted, this pattern fell distinctly short of the strategically coordinated change that might have preserved the institutional complementarities that characterized earlier periods of German economic adjustment. The alternatives to coordinated change were, however, not limited to wholesale concessions to neoliberal recipes for marketization. If critics from the Left saw the Red-Green tax reform as a massive (and inexplicable) concession to the financial services industry, critics from the Right saw the renewal of plant-level codetermination as a refusal to jettison outmoded features of Germany's social-market economy. The apparent inconsistency reflected more than the Chancellor's tactical sense for balancing electoral constituencies. These measures expressed a de facto strategy of second-order change, by which the Red-Green coalition pushed the organized social partners to expand their membership and include a broadened set of constituencies within their own deliberations.

The efforts of the Red Green coalition to promote economic adjustment during its first four years in power display variable degrees of success in the three policy domains discussed above. By emphasizing the "neue Mitte" in his initial campaign, Schroeder conveyed a clear intention to identify a new social democratic majority that would support his "Third-Way" or "modernizing" approach to a new constellation of solidarity and individual opportunity. In the event, however, Schroeder had difficulty assembling the new social democratic middle and therefore depended significantly on the environmentalist Greens for his public support. The new coalition was an uneasy amalgam. The Social Democrats were searching for a new electoral recipe. The Greens meanwhile sought to exercise their role as junior coalition partner for the first time, but

could only do so by simultaneously clarifying and advancing a not entirely consistent set of priorities that ranged from individual autonomy to environmental sustainability.

Despite the tensions between the two parties, some of the leading factions within each of them agreed upon the need for change in the internal composition of Germany's key social interest groups. The so-called "modernizing" wing of the SPD and many of the Green parliamentary leaders saw a pressing need to create more low-wage jobs, even at the expense of offending organized labor. Once the Chancellor's extra-parliamentary effort to achieve job growth through the Alliance for Jobs was blocked, the new government settled upon a de facto approach that we have call an improvised strategy of "second-order change." This approach appeared in both the 2000 tax reform and the revision of the BVG in 2001. The first legislative initiative created relatively hospitable conditions for new firms that wanted to enter the services sector by reducing taxes on smaller enterprises and shielding them from some of the compensatory revenue-producing measures (*Gegenfinanzierung*) that fell more heavily on manufacturing firms. The second piece of legislation explicitly reinforced employee representation through firm-level codetermination. In so doing, the legislation appeared to support organized labor's requirements, but it did so in a way that meant unions would either have to organize substantially smaller firms in the services or leave the works councils in those firms to be occupied by non-union employees. In both cases, the new legislation complicated life for the organized social partners by creating marginal advantages for "outsiders," that is, for individuals and organizations who had not previously participated in the recognized peak associations.

Interestingly, both initiatives included measures that altered the conditions under which small and medium-sized firms could enter the services sector. The tax reform clearly sought to unwind long-term industrial holdings and thereby to make patient capital available for investment in newer growth sectors. The renewal of the codetermination rules extended the legal safety net that the unions had considered essential. For this reason, the renewal of the BVG signified a clear victory for organized labor and a blow against any purely neoliberal or deregulatory approach to entrepreneurship. While strengthening the basis for employee rights in smaller firms, however, the legislation did little to guarantee that those rights would be exercised by union-dominated works councils rather than by non-union forms of employee representation.

Both pieces of legislation thereby promised to promote experimentation in the financing and the governance of smaller firms. The desire to promote small firm entrepreneurship was only at first glance counterintuitive for the Red-Green government. It formed a logical part of the Greens' desire to push the social bases of German politics away from traditional concentrations of power. And even before the Red-Green coalition gained office in Berlin, small-firm employment strategies were becoming popular among social democratic politicians in several regions. When the coalition was reelected in 2002, Schroeder quickly asked one such regional leader, the Minister President of North Rhine Westphalia, Wolfgang Clement, to lead a merged cabinet portfolio for Economics as well as Labor. Almost immediately there appeared a strong affinity between the Greens' economic spokespersons and the social-democratic modernizers who worked

under Clement's supervision in the new super-ministry.<sup>98</sup> Since 2002, the virtues of small-firm employment strategies have become a virtual mantra among all parties in Berlin. As the areas examined above show, however, there was a clear undercurrent of interest among Red-Green policymakers in promoting the *Mittelstand* throughout the coalition's first four years as well. Since Germany's traditional *Mittelstand* had been a stronghold of support for the center right, the Red-Green coalition's interest in promoting entrepreneurship stemmed not from any short-term electoral calculation but rather from the coalition's desire to shift the internal composition of Germany's traditionally hierarchical and centralized social partners. It was this indirect but persistent effort to create new conditions by opening the boundaries of the political arena to previously unrepresented interests that we have called the improvised strategy for second-order change.

This legislative record was "improvised" in the sense that it followed no fixed or even particularly consistent set of preferences. Instead it emerged through ongoing political discussion between the two coalition partners and in response to the changing opportunities generated by each policy initiative. At the same time, the intention behind the legislative record deserves the term "strategy" because it embodied much more than a random result of grass-roots ideas percolating up from the German electorate or economy. Each of the coalition partners had an evolving but identifiable set of preferences that they continually advanced and repackaged in their efforts to drive

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<sup>98</sup> See for example "Ein super Minister: Warum Wolfgang Clement die Grünen glücklich macht," *SD*, December 14, 2002.

legislative reforms forward.<sup>99</sup> For this reason, the important institutional changes that began to occur in the Red-Green government's first four years cannot be understood strictly by way of extrapolation from prior institutional dynamics. The preferences of the parliamentary elites were crucial. The Greens brought a distinctly new set of goals into the national Ministries. The Social Democrats were for their part actively debating and puzzling over new ways of defining solidarity.

The expanded play of preferences was evident in the variation of outcomes in the three cases analyzed here. In Chancellor Schroeder's frontal attempt to create a low-wage segment in German labor markets, the traditional partners in peak-level bargain simply blocked any significant change. In the tax reform, the Red-Green coalition imposed a "modernizing" overhaul that went far further in the direction of business's interests than most observers would have predicted (or, even quite grasped at the time). In the case of renewing plant-level codetermination, the coalition largely respected the demands that organized labor articulated. It is therefore impossible to see any single formula by which the coalition leaders calculated an optimal compromise among contending interest groups. This trio of policy initiatives clearly shows an evolving strategy to effect institutional change indirectly, and to do so through a pragmatic set of linked policy packages.

This evidence suggests strongly that studies of institutional change should not be limited to cross-national comparisons in a single policy area. As important as cross-national studies will clearly remain, they need to be supplemented by cross-domain comparisons within a single country. It is only through a broad-gauged examination of

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<sup>99</sup> Preferences here evolved in response to emerging opportunities. For a similar treatment, with preferences changing in response to more discrete events, see Peter Hall, "Preference Formation as a Political Process: The Case of European Monetary Union," March 2003.



the stakes across the entire spectrum of change that we can firmly grasp the interplay of preferences and inherited institutional regularities that appear in periods of change. In keeping with Ira Katznelson's cautions,<sup>100</sup> by making too quick a distinction between periods of continuity and periods of change, we can unintentionally bracket important aspects of politics out of our field of vision. The course of institutional change in Germany puts the problem of defining critical junctures in high relief. If reunification was a critical juncture, we need to map its consequences and delimit its duration. The evidence assembled in this paper indicates that the answers to these questions depend on the efforts of political parties much more than institutionalist perspectives might suggest. Whether their efforts fell into the realm of the brilliant, or the mundane, the ability of partisan leaders to define challenges coherently and propose solutions realistically was an essential factor in any convincing explanation for the politics of economic reform during the first four years of Germany first Red-Green coalition.

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<sup>100</sup> Katznelson, "Periodization and Preferences," in J. Mahoney and D. Rueschemeyer, eds., Comparative Historical Analysis in the Social Sciences (New York: Cambridge University Press, 2003).