Ideas, Institutions and Organized Capitalism: Germany, Europe and 21st Century Economic Policy Models[*]

By Christopher S. Allen
DAAD/AICGS Fellow
Josiah Meigs Distinguished Teaching Professor
Department of International Affairs
University of Georgia

Introduction

For much of the past two decades, the literature on the German economy has largely focused on the erosion of the German form of organized capitalism and emphasized institutional decline and the corresponding rise of neo-liberalism. Yet, in the past few months, the world-wide financial crisis has challenged the virtues of the apparent neo-liberal hegemony and perhaps opened up once again a debate regarding appropriate economic policy models. Yet for all of the discussion of the apparent shortcomings of *Modell Deutschland* (which the first part of this essay will briefly review), most of this critical literature has focused on the demise of this postwar economic policy model. This essay will take a different focus; it asks the question why such a model was created in the first place and whether a renewed form of it might still be useful for developed democracies in the early twenty-first century.

Specifically, it argues that the formation of this organized capitalist model (also known as a coordinated market economy) – not only in the postwar period but also

---

[*] I would like to thank Jeffrey Anderson and Carolyn Forestiere for comments on an earlier version. This essay is part of a larger book manuscript in process; for a more extensive working paper on this theme, please consult my website (Uhttp://csallen.myweb.uga.eduU) or contact me at Ucsallen@uga.eduU. Comments are welcome.

AICGS would like to thank the German American Academic Exchange Service (DAAD) for the support of this essay. This essay appeared in the December 19, 2008, AICGS Advisor. http://www.aicgs.org

during Germany's rapid industrialization in the late nineteenth century – arose because an Anglo-American free market model was inappropriate for generating the economic growth that each epoch required. It also argues that the creation of this policy regime was comprised of dynamic, flexible institutions and a clear set of visionary ideas in the context of either state-building or state rebuilding. The next part of the essay articulates the components of these coordinated market economy models during both the Bismarckian and Social Market Economy periods. The final section of the essay inquires whether the failure of the neo-liberal model in the wake of the worldwide financial collapse and severe recession represents a possible opening for the creation of a third organized capitalist model not only for Germany but for a redesigned European Union.

The Demise of Modell Deutschland

The litany of shortcomings of the postwar form of German organized capitalism is by now well known. Since the 1990s, the German economy has been beset with increasingly uncompetitive industries, persistent structural unemployment, and continued stagnation in eastern Germany. In addition the large German banks, which for more than a century served as a guardian for dozens of German firms, began to sever their "*Hausbank*" relationships with large German firms in favor of focusing on global opportunities and global profits. Within the formerly cooperative corporatist industrial relations system, we have seen for more than a decade German employers deserting their employer associations in favor of "going it alone" with negotiations among the unions. In addition, the latter have fared poorly in the past two decades with the share of German workers in trade unions dropping by almost half, now representing less than 20 percent of the German workforce. Finally, the Social Democratic Party (SPD), once the exemplar of "capitalism with a human face" after its first years as the leading party in government in the 1970s, has recently turned to serious retrenchment in the form of the Hartz IV labor market that victimized many of its own supporters during the Schröder governments of the early 2000s, only to lose control of government in the 2005 election.

The inglorious end of Germany's "model" organized capitalist economy came to be characterized as one comprised of cumbersome, limiting, sclerotic institutions incapable of adaptation and that only a turn to neo-liberal market approaches could pull the German economy out of the doldrums. The 2008 financial crisis has clearly cut short the enthusiasm for neoliberal solutions both in Germany and elsewhere, but the standard consensus still remains that the current version of the Germany's organized capitalist economy doesn't offer much promise.

Institutional Innovation, Visionary Ideas, & State (re)Building

One can tell a great deal about the organization of a nation's economic policy by understanding the country's timing of industrialization and democratization. Countries that industrialized early tended to have laissez-faire, free market economies that gradually evolved into the world's leading economies because their good fortune and path-breaking industrialization allowed them to assume that they could have relatively easy access to resources, markets and capital. The UK and the U.S. are the prime examples of this pattern. Countries that industrialized later, such as Germany and Japan, faced a different set of choices. Lacking ready and predictable access to resources, markets and capital, they needed to construct a different set of institutions if they were to catch up to the

AICGS would like to thank the German American Academic Exchange Service (DAAD) for the support of this essay. This essay appeared in the December 19, 2008, AICGS Advisor. http://www.aicgs.org

earlier industrializers. In short, they needed to construct a model that: maximized efficient access and use of resources; targeted foreign markets since their own domestic markets were so underdeveloped; and allocated capital so that each investment had a high probability of success. Unlike the "trial and error" economies of the earlier industrializers, the later industrializers had much less margin for error.

Latecomers such as Germany – and other continental European nations – needed to create a set of institutions that could accomplish economic development quickly because following the gradual, evolutionary path of the UK and the U.S. would have been disastrously insufficient, and ultimately too late. In both the Bismarckian period as well as the Social Market Economy period, the laissez-faire option was simply not available. While Bismarck was able to use the state as an entrepreneur, that option was not available in the post-World War II period due to the Nazis' colossal abuse of state power. However, both epochs did share the use of a universal banking system and close coordination among major producer groups (cartels in the nineteenth century, *Verbände* in the mid-twentieth) as significant entrepreneurial forces. Not surprisingly, rapid economic transformation based upon industrial development and largely export-led growth did not offer much immediate benefit to ordinary Germans. Both Bismarck and the "fathers" of the Social Market Economy (Konrad Adenauer and Ludwig Erhard) realized that such social dislocation required protective social policies. Such policies were not offered out of the goodness of the hearts of these leaders, rather they were preventive policies to minimize social tension and political opposition while the economy grew. Bismarck's creation of the first social insurance schemes (while simultaneously banning the then revolutionary Social Democratic Party) was one mechanism. Another

AICGS would like to thank the German American Academic Exchange Service (DAAD) for the support of this essay. This essay appeared in the December 19, 2008, AICGS Advisor. http://www.aicgs.org

was the less draconian formation of the Social Market Economy which provided the beginnings of the postwar German welfare state in Germany's first stable democracy.

Unlike more open free-market oriented economic policy models that had few constraints in terms of resources, markets and capital, an organized capitalist or coordinated market economy is very much an "all eggs in one basket" phenomenon. To make this work required people with visionary ideas to imbue these institutions (banks, firms, *Verbände*, works councils, unions, para-public service providers, etc.) with innovative, transformative policies that provided a total that was greater than the sum of the parts. Institutions may turn into inefficient Weberian bureaucracies when allowed to atrophy. But when imbued with a larger public purpose such as invigorating an economy when the usual market approaches are not available or when building or re-building a nation state, in the right hands and with far-reaching vision, they can be much more dynamic than conventional wisdom holds. In fact we have the proof of the capacity of institutional transformation in the presence of Germany's largest banks (Deutsche, Dresdner, Commerz) and firms (Siemens, Daimler-Benz, BASF, Bayer), all of which have existed for over a century amidst periods of great turmoil.

What specifically were the institutions and the ideas and the state-building context that made these two epochs possible? During the latter half of the nineteenth century, first Prussia and then a united Germany created a universal banking system (the idea borrowed from Louis Napoleon's *Credit Mobilier*) that focused on long term, targeted investment in the dominant industries of the "second industrial revolution" (coal, steel, chemicals, machine tools, railroads, industrial electronics). This required large sums of money and the newly created firms in these sectors were unable to raise the funds

AICGS would like to thank the German American Academic Exchange Service (DAAD) for the support of this essay. This essay appeared in the December 19, 2008, AICGS Advisor. http://www.aicgs.org

themselves of from the primitive stock markets of the time. By virtue of loans, ownership of company stock, holding proxies for the firms' shareholders, and having seats on the board of directors, the banks – aided by the Prussian and then German state – played a significant role in the industrial direction of these firms. And by having deep pockets and a longer term horizon, it enabled these firms to establish their position in world markets. The *Verbände* (cartels at the time) were essential since the members of the cartel did not see themselves as competitors of one another. Rather they viewed their competition as principally other industries in other countries and the members' collaboration allowed them to maximize their respective strategies. Skilled labor was also increasingly important for most of these industries and these firms were able to build on the legacy of the guild system which produced workers of exceptionally high skills. Finally, Bismarck used the state more as an architect rather than in a micro-managing interventionist way.

What were the visionary ideas that embodied these institutions? One was the "marriage of iron and rye" that Bismarck forged between the feudal Prussian lords (*Junker*) who needed a way to get their grain to market and the new money industrialists who needed cargo to transport on the new rail system. The second was Bismarck's "iron fist in a velvet glove" that saw him first ban the SPD in 1878 but then initiate one of the SPD's major demands, namely the creation of a welfare system, in the 1880s. When the SPD was made legal again in 1890, they were a much less revolutionary party.

This juncture of ideas and newly created institutions took place in a context of state building that made many of these actions possible. To be sure, this was not a stable foundation that Bismarck had built, as he had to rely on aggressive nationalism and considerable political repression as major tools. This autocratic version of the organized

AICGS would like to thank the German American Academic Exchange Service (DAAD) for the support of this essay. This essay appeared in the December 19, 2008, AICGS Advisor. http://www.aicgs.org

capitalist model was economically and politically successful for a time, but it contained the seeds of its own destruction as World War I, Weimar, the Great Depression, and the Third Reich painfully show. But if Germany was to industrialize and unify in the nineteenth century, it is hard to see another viable path.

Many observers of contemporary Germany have seen the post–World War II period as "*die Stunde Null*" and the 1949 founding of the Federal Republic as a sharp departure from all that had happened in Germany over the previous century. Yet, for those who looked closely at the foundational elements of the political economy of the FRG, there was an unmistakable continuity with the late nineteenth century. The Allies' original plan for Germany after the war as proposed by U.S. Secretary of the Treasury Henry Morgenthau was to de-industrialize Germany and emphasize agriculture. However, the Cold War and imperatives to restore a functioning German economy trumped such fanciful concerns. Thus both public and private sector German actors chose familiar patterns of industrial organization to rebuild the country since a trial-and-error free market model was once again off the table. Since speed of industrial development was paramount, German banks and large German firms adopted familiar organized patterns and universal banking, with its deep ties to larger German firms was quickly reestablished providing a stable and profitable link between finance and manufacturing. But since this form of organized capitalism took place under democratic auspices, other institutions re-emerged to act as a check on arbitrary power by the financial and manufacturing community. German unions expanded the concept of the earlier *Betriebsräte* (works councils) to establish a democratic corporatism in which labor played a much more prominent part than it did under Bismarck. The trade unions and

AICGS would like to thank the German American Academic Exchange Service (DAAD) for the support of this essay. This essay appeared in the December 19, 2008, AICGS Advisor. http://www.aicgs.org

their allies in both the SPD and the CDU/CSU agreed to *Mitbestimmung* (codetermination) which gave trade unions membership rights on the boards of all large German companies. This second organized capitalist model in Germany also saw a unique form of framework regulation (*Rahmenbedingungen*) which acted not like American-style regulation that tries to belatedly address specific market failures like a fire brigade; rather *Rahmenbedingungen* regulated the general rules of the game, more like an architect. Significant examples of this were encouraging banks to maintain extra high capital adequacy reserves and vetting all of those who held responsible positions in the financial sector. These framing regulations proved crucial for the health of the economy since, once again, Germany was creating an "all eggs in one basket" set of institutions.

The visionary ideas that animated this second iteration of a coordinated model came from a group of economists who were collectively known as the Freiburg School. Acknowledging that a laissez-faire policy would not work in a country with no history of it, and that the use of the state as an entrepreneur had been fatally compromised by the Third Reich, the Freiburg School economists developed an economic theory that refused to frame economic policy as a stark choice between state and market that was most succinctly articulated by Wilhelm Röpke during the early years of the Social Market Economy:

> "….(our program) consists of measures and institutions which impart to competition the framework, rules, and machinery of impartial supervision which a competitive system needs as much as any game or match if it is not to degenerate into a vulgar brawl. A genuine, equitable, and smoothly functioning competitive system can not in fact survive without a judicious

AICGS would like to thank the German American Academic Exchange Service (DAAD) for the support of this essay. This essay appeared in the December 19, 2008, AICGS Advisor. http://www.aicgs.org

> moral and legal framework and without regular supervision of the conditions under which competition can take place pursuant to real efficiency principles. This presupposes mature economic discernment on the part of all responsible bodies and individuals and a strong impartial state…"

The second visionary idea that emerged as a guiding principle of the Social Market Economy was the conception of innovation. In liberal market economies that celebrate the role of the individual, innovation is generally characterized by lone individuals or small firms discovering new products. But in coordinated market economies without this laissez-faire tradition, innovation came to be defined in very different ways. Rather than inventing new products, the large German firms would adapt inventions developed elsewhere and then integrate them into the production process and improve existing products that they already produced. Perhaps that most obvious manifestation of this pattern is the long-running television commercials (shown in the U.S.) of the German chemical firm BASF that conclude: "We don't make (product x); we make (product x) better."

These renewed institutions and context specific ideas took place at a time when Germany could not function as a "normal" nation state and when many questioned its ability to "behave" as a democratic polity. The country's ability to renew these economic institutions but frame them in a way that enhanced rather than retarded political democracy enabled Germany to emerge over succeeding decades as the economic, and eventually, the political lynchpin of Europe.

The erosion of this second model of Germany's organized capitalist economy did not go the way of the first, with a "bang"; rather it eroded more with a "whimper." To be sure, at the beginning of the 1990s, Germany faced three exogenous shocks which contributed to the erosion of the efficacy of this second iteration of organized capitalism. The combination of accelerated globalization, the expansion of the EU with its neoliberal directives that whittled away the nationally-specific German coordinated market institutions, and finally the stresses of unification have been powerful forces that have challenged this model.[1] There also were endogenous forces that eroded this model. First, this particular model thrived in both epochs as one that was created to “catch up” with economic powers that were more advanced. Yet by the 1980s, Germany was seen as rivaling Japan as the two leading candidates to displace the U.S. as the leading capitalist countries. This did not come to pass, of course, but it raises the larger issue of whether this model is suitable once it “catches up.” Part of the problem here is that while non-Germans could see and articulate how this model worked, Germans themselves were remarkably reticent about touting it as an explicit model. But they were also complacent about assuming that their Social Market Economy would keep working, even though the Freiburg school economists whose ideas animated the model had long expired. This ambivalence prevented them from understanding how much a threat the neoliberalism of the Anglo-Americans in the 1980s, and later the EU itself were a threat to Germany’s nationally specific model. In the 1990s and 2000s, much of the architecture of this model, while still physically present, had lost much of its original functionality; and more important the ideas that once animated it.

---

[1] German unification here is initially viewed as an exogenous shock, but it has now become endogenous. The European Union is viewed principally as an exogenous shock, even though Germany’s role as a founding member of the organization suggests and endogenous role. The point here is that the neoliberal ethos of the EU’s economic policy was very much at variance with that of Germany’s organized capitalism.

AICGS would like to thank the German American Academic Exchange Service (DAAD) for the support of this essay. This essay appeared in the December 19, 2008, AICGS Advisor. http://www.aicgs.org

Economic policy models can erode in different ways: dramatically and catastrophically, as well as slowly and quietly. But what is similar in both forms of erosion is that the institutions that once were their foundation and the ideas that once animated them were no longer capable of responding to newer challenges.

Towards a Third Organized Capitalist Model?

One of the virtues of writing an essay that attempts to extrapolate from the past to the future is that it is very difficult to know what the outcome will be, thus leaving the writer somewhat "off the hook." Perhaps, but if using frameworks that embrace historical institutionalism and path dependence, two schools of thought upon which the larger project of which this essay is drawn, are to be useful, there should be some reasonable expectation of a payoff. What this conclusion will offer are three scenarios that assess the likelihood of Germany and the EU developing a policy model that bears some resemblance to the first two models articulated above.

The first scenario would hold that, for all of the financial crisis and attendant economic dislocation, the neoliberal agenda, particularly as instituted by the EU and apparently embraced by most European social democratic parties, has simply progressed too far. Furthermore, this view would argue that the age of national models has passed and that globalization is just too powerful a force to allow for the social protections that the older models embodied. Together with the hyper mobility of both capital and labor, the erosion of the core organized capitalist institutions, "hard" laissez-faire policies and the role of the EU in eroding national sovereignty in both monetary and fiscal policy, it is easy to make the case that the easy "exit" from these institutions has destroyed the

AICGS would like to thank the German American Academic Exchange Service (DAAD) for the support of this essay. This essay appeared in the December 19, 2008, AICGS Advisor. http://www.aicgs.org

capacity for use of the “voice” necessary to rebuild them. But the great unknown in the wake of the international financial crisis and extremely serious recession of 2008 is whether these forces can dislodge the power of neoliberal forces within the EU and among many of the national governments of Europe.

The second scenario would see no dominant model emerge. Even now within Germany, one can see evidence of this trend. While the large German banks have “gone global” (to the recent consternation of some of them), many of the smaller regional and local banks still maintain a “*Hausbank*” relationship with firms in their local regions. This second scenario would see a number of unfocused experiments with no coherent policy. In other words there would be regional and sectoral examples of both organized and laissez-faire economic policy models with neither becoming hegemonic in Europe.

Finally there could be a third scenario that would produce a model reminiscent in the spirit – but not the letter – of the first two models. Until the financial crisis hit a few months ago, this was likely the least likely of the three scenarios. But let us step back and look at the conditions when these two earlier organized models tended to thrive: when markets either were not available or had failed. We are now, once again, in one of these moments. When the essential features that animate the liberal market economy (access to resources, markets and capital) are no longer easily attained, then neoliberalism looks far less hegemonic, or even attractive as an economic policy model. Among the questions that have not been asked during the neoliberal ascendancy are existential ones about the purpose of capitalism itself. Is it just for financial innovation for its own sake with little concern for the production of needed goods and services in the “real economy”? Is long term oriented investment, necessary for larger projects with slower expectations of

AICGS would like to thank the German American Academic Exchange Service (DAAD) for the support of this essay. This essay appeared in the December 19, 2008, AICGS Advisor. http://www.aicgs.org

profitability no longer important? Is human capital formation, essential for productivity growth, no longer seen as a collective good for all firms or is it proprietary for only those firms who can afford it at the moment? Is a functioning social welfare state that can soften the blow for those who are displaced by this economic transformation no longer necessary?

If these are important goals for a modern developed economy, then adapting the spirit of earlier organized models might be of much greater use than continuing to press for a neoliberalism that has shown some extremely serious shortcomings in 2008 and apparently offers no better options for the near future. But there is one large problem that a third generation of “model builders” must face: the age of national models in Europe is over. Any such construction would have to confront the redoubtable architecture of the EU. In the late-80s “Europhoria” days, many Europeans believed that they could embrace the advantages of Europeanization without any serious consequences. But when increasingly neoliberal treaties and directives were adopted and individual nation states saw their sovereignty eroded in the form of reduced control over fiscal policy (the 3 percent mandate regarding deficit spending) and monetary policy (for those 12 countries that have joined the Eurozone), political power had clearly been transferred to Brussels without the possibility of return. If these policies are to be changed and a coordinated market economy is to replace it, Europe would need to address the lack of political accountability that the EU has not yet addressed in the form of a polity and not just a market. This scenario is clearly a long term project, but if Europe wishes to avoid economic catastrophe and create a stable political environment, then there are clearly options that offer more promise than the neoliberalism that seems to be coming apart.

AICGS would like to thank the German American Academic Exchange Service (DAAD) for the support of this essay. This essay appeared in the December 19, 2008, AICGS Advisor. http://www.aicgs.org