The London School of Economics and Political Science

The Art of the Almost Impossible: Three Essays on the Political Economy of Structural Reforms in Europe

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Declaration

I certify that the thesis I have presented for examination for the MPhil/PhD degree of the London School of Economics and Political Science is solely my own work other than where I have clearly indicated that it is the work of others (in which case the extent of any work carried out jointly by me and any other person is clearly identified in it).

I declare that my thesis consists of 64,746 words (including footnotes, excluding bibliography).

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I confirm that Paper One is based on the result of previous study (MSc European Studies Research) undertaken at European Institute of the London School of Economics and Political Science.

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I can confirm that my thesis was copy edited for conventions of language, spelling and grammar by Chris Steele, Transformat, London.

To Bob,
for providing broad shoulders to stand on

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Summary

The *Introduction* – together with the conclusion – provides a framework for the three substantial contributions of this PhD project. It begins with sketching a puzzle that motivates research on the political economy of structural reforms in Europe, namely the inconsistency between the commitment of governments to reform and the actual reform track record across the countries. It discusses the nature and findings of the relevant multidisciplinary political economy literature. *Paper One* addresses the puzzle why the first major post-war overhaul of the German political economy – the 'Agenda 2010' reforms – was undertaken in 2003 by a social-democratic government and not by any of the conservative governments that preceded it. It finds that the lack of government cohesion, the federal legislative system and corporatist structures remain important determinants for institutional stability and change in Germany. *Paper Two* develops a theoretical argument as to why corporatist European economies may live through extended periods of economic underperformance without significant reform. Building on this argument, it presents a formal model, from which it derives a set of determinants for structural reforms, and finally illustrates these by exploring the causes for reform in Germany and Sweden. *Paper Three* uses a new database on labour market reform to show that corporatist structures have an intermediating effect on the determinants of structural reform policies. It finds evidence that the interests of employer organisations and trade unions matter for the labour market reform trajectories in countries with corporatist features. Political partisanship and economic crises matter more in pluralist countries. Finally, the *Conclusion* summarises the findings of the three papers. Subsequently, it outlines the limitations and draws up some wider implications for the theories of institutional change and for public policymaking.

Contents

Preface and acknowledgements

Otto von Bismarck famously said that politics was ‘the art of the possible’. In the context of the expansionary foreign policy of the European powers in the 19th century, Bismarck warned against policy objectives that were outside the reach of the respective sovereign. Bismarck’s words must echo in the minds of many European politicians when faced with the challenge of adjusting the institutional structures of their countries, in view of growing global competition, fast advances in technology and an ageing population. In fact, for a long time structural reforms to Europe’s labour markets and welfare regimes was considered almost impossible.

This policy problem has been with me since my Master’s thesis (*Diplomarbeit*) at the Department of Economics at the Ludwig-Maximilians-University of Munich in 2004. Prof Monika Schnitzer, my supervisor in Munich, suggested investigating the political economics literature on structural reforms and its explanatory power. These were turbulent political times, just after the German government under Gerhard Schröder had successfully implemented the most significant post-war overhaul of the German labour market and welfare system. The reforms came as a surprise not only to the stability-oriented Germans, but also to many researchers, for whom inertia and gradualism had become a hallmark of policymaking in Germany and other European countries. Against this political and academic background, I decided to pursue the investigation of the political economy of structural reforms in the context of a doctoral degree programme.

When I first joined the European Institute of the London School of Economics and Political Science as a research student in 2005, I was confronted with a different form of political economy research than I had known. It is more informed by the institutional analysis of political scientists and the broad perspective of macroeconomists, than the relatively narrow, rational choice perspective of micro-based political economics. The interaction between institutional structure and macroeconomic performance in the comparative capitalism literature, in particular, seemed to offer scope for important insights also on the determinants of structural reform policies.

I began the research project – as much as possible keeping an open mind on possible results – with a case study of the Agenda 2010 reforms in Germany. This already provided much evidence that structural reform trajectories in Europe are only understood against the background of the close interlocking of the political and economic sphere. This first impression was confirmed by interviews and background discussions with government officials and labour representatives as well as with some of the engineers of the *Modell Deutschland*, such as the former chairmen of Deutsche Bank and Allianz SE. It was also confirmed by insights gained as a staff member of the European Central Bank, where I spend time twice and – in the view of my supervisors – in culpable negligence of my research work at the LSE.

The subsequent research done for the PhD project includes, in particular, a rational choice model of a 'coordinated' European political economy and a quantitative investigation on the determinants of structural reforms in Europe. These benefited from my tenure as a visiting research student at the Graduate School of Arts and Sciences at Columbia University. The third paper, in particular, would not have been possible without the 'Social Reforms Database' of the Fondazione Rodolfo DeBenedetti in Milan and the Institute for the Study of Labour in Bonn, in the development of which I was involved as one of the 'country experts'.

The final output of this research effort are three academic papers. While each of the three papers addresses the same broad set of questions, they reflect my interdisciplinary background as an economist and political scientist. Bridging the divide between the two disciplines has been difficult, sometimes leaving me with a feeling of academic schizophrenia. Nonetheless, I sincerely hope the results provide some indication that there is additional value in looking across the social sciences for answers to empirical questions.

Some words of thanks are in order. I should like to thank, in particular, my first supervisor and *Doktorvater*, Dr Bob Hancké, for inviting me to come to the European Institute, and for accompanying my research project with professional guidance and fatherly friendship. My thanks also goes to my second supervisor, Prof Willem Buiter, for giving important impulses, particularly in the early stages of the research. Further, I am grateful to Dr Waltraud Schelkle and Dr Christa van Wijnbergen as well as many other staff members of the European Institute for their continued advice and support. Among my peers, I have to single out Dr Costanza Rodriguez d'Acri, who accompanied this project from start to finish, as well as Dr Lior Herman. And I should not forget to I thank all the supportive friends and colleagues in the European Institute's Jean Monnet Room, aka 'J14'.

Last and most importantly, my deep-felt gratitude goes to my family, who has been extremely supportive of the 'perennial student', both emotionally and pecuniary. Here, I would like to mention my parents, Dr Rolf and Juliane Freier, my dear grandfather, Gotthold Meyer, and my wife, Christine Herion.

London and Frankfurt a.M.
June 2012

Preface to revised version

The following PhD thesis has been significantly revised following its first submission in June 2012. Important revisions include, among others, the addition of a definition and a discussion of the term ‘structural reforms’ in the introduction to the PhD project. Paper One now comprises a theoretical contribution in form of an ‘enhanced veto player framework’ and the empirical section of the paper has been revisited. The theoretical discussion and model in Paper Two have been revised to provide a clearer perspective on the role of government in ‘coordinated market economies’. An additional subsection has been introduced to provide some intuition on how this type of economy can move from one coordinated equilibrium to another. The quantitative analysis in Paper Three has been given a stronger theoretical underpinning and is based on an alternative measure for corporatism. Estimations have been rerun and results are presented in a more concise and clear way. The Conclusion has been revised to emphasise more strongly important differences between the three papers of the research project.

I would like to thank the examiners, Dr Vassilis Monastiriotis (London School of Economics) and Prof David Rueda (University of Oxford), for their constructive comments and suggestions, which have allowed for a substantial improvement of the analysis.

Frankfurt a.M.
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Introduction
Political economy of structural reforms: An interdisciplinary analysis of the state of play

1.1 Introduction

Structural reforms have been on the policy agenda since the oil crises of the 1970s when – for the first time since the Second World War – economic growth stagnated and unemployment rose in most of the Western world. When the established, demand-oriented Keynesian policies failed to sustainably address the problem, policymakers started turning to an alternative, supply-side policy paradigm.[1] To reduce rigidities and other inefficiencies in the structure of the economy, the policy approach suggests reforms to deregulate product and labour markets, privatise state enterprises, liberalise trade and exchange rate regimes, practise fiscal discipline and reduce tax rates, among other things.

At international level, this policy paradigm found its definitive policy formulation following the end of the Cold War in the so-called 'Washington Consensus' (Williamson 1994a, 17f.). In the European Union (EU), the commitment to supply-side reforms were jointly and formally adopted in the 2000 Lisbon Agenda, which famously aimed to make Europe 'the most competitive and dynamic knowledge-based economy in the world' within ten years.[2] In spite of persistent criticism, particularly from the political left, and repeated revisions of the specific policy recommendations, the market-oriented, supply-side reform agenda has broadly remained in place through the 1990s and 2000s. Accordingly, it is reflected in numerous international and intergovernmental policy statements and publications.[3]

In short, the three decades before the global financial and economic crisis of the late 2000s saw wide political agreement on the appropriateness of market-oriented structural reform, both at international and European level. However, the reform track record of European countries, in particular, displays

[1] Building on insights of neoclassical economics, the so-called 'neoliberal paradigm' advocates promoting growth and employment by 'liberating individual entrepreneurial freedoms and skills within an institutional framework characterized by strong private property rights, free markets, and free trade.' (Harvey 2005, 2).

[2] To reach this ambitious goal, the EU member states were urged to adopt a wide array of policy measures, including more investment in research and development, improved skill levels of young people and increased work participation of women. But the Lisbon Agenda also called for extensive supply-side reform; it contained policy prescriptions for the liberalisation of the product market, for the reform of labour regulation and for the modernisation of welfare institutions.

[3] For example, structural reforms have been an important policy objective of the OECD through the 1990s and 2000s (OECD 1996, 2005, 2006, 2007, 2008) and remain so today. Similarly, the G7 countries agreed on an 'Agenda for Growth' in September 2003, a joint commitment of the governments to supply-side 'structural policies that increase flexibility and raise productivity growth and employment.' (Group of Seven 2003) The G7 'Agenda for Growth' was expanded into the G20 'Accord for Sustainable Growth' in 2004.

large disparities between this aspiration and policy reality. In its 2004 World Economic Outlook 'Fostering Structural Reforms in Industrial Countries' the IMF finds the following:

> Reflecting a broad consensus about the substantial benefits of structural reforms, a general, worldwide trend toward more market-friendly regulatory frameworks and policies has prevailed since the early 1980s. The scope and speed of structural reforms has, however, differed widely across countries and sectors. Among industrial countries, the variation is especially large in Europe where, despite welcome steps, excessive product and labor market regulations continue to be obstacles to growth and employment. (IMF 2004, 103)

On the one hand, the United Kingdom followed much of the rest of the Anglo-Saxon world – the United States, Australia, New Zealand in particular – and implemented far-reaching liberal-market reforms in the early 1980s. For example, the highly-contested Thatcherite policies of the 1980s – rolling back the influence of the trade unions, the liberalisation of markets and reduction of tax rates – fundamentally realigned its socio-economic structures (Reitan 2003). Similarly, most of the transformation countries in Eastern Europe implemented radical market-oriented reform after the fall of the Iron Curtain, broadly following the blueprint of the Washington Consensus (Roland 2004).

On the other hand, the implementation of supply-side structural reforms in the countries of the western European continent is perceived to have fallen short of the commitments made. To some degree, this perception relates to the inability of these countries to reach the arguably overambitious goals set forth in the Lisbon Strategy (Collignon 2008, Wyplosz 2010, Lundvall & Lorenz 2012). In 2009, the Swedish presidency of the EU proclaimed: '[I]t must be said that the Lisbon Agenda, with only a year remaining before it is to be evaluated, has been a failure.'[4]

The overall negative assessment of the Lisbon Agenda, however, obscures significant variation in the structural reform trajectory also in countries of continental Western Europe. In the ongoing crisis in Europe, these divergences in structural reform paths among countries that share the euro as their currency

[4] Swedish Prime Minister Fredrik Reinfeldt, 2 June 2009, reported on EurActive.com, `http://www.euractiv.com/priorities/sweden-admits-lisbon-agenda-failure/article-182797` (retrieved 01.02.2012 17:29) Already in 2003, a mid-term review of the Lisbon Strategy – the so-called 'Kok Report' – finds that 'progress to date has been inadequate.' (Kok 2004, 39)

have gained new policy relevance. European policymakers widely hold the view that the woes in Europe's crisis countries are attributable – to a significant degree – to the failure of these countries to implement market-oriented structural reforms. This resulted in unsustainable competitive divergences with other European countries that adjusted the structures of their economies more successfully.[5] To overcome the crisis, it is argued, the 'more vulnerable countries must leave no doubts about their willingness to reform.'[6]

This renewed political attention to structural reforms underlines the salience of political economy research on reform trajectories in Europe: Why have countries of the western European continent not implemented more radical supply-side reforms in view of the broad policy consensus on these policies? Why do these European countries – which are commonly held to be quite similar in terms of socio-economic and political structure – display significant divergence in their structural reform trajectories? Why do some countries reform their structures while others do not, in spite of institutional arrangements commonly held to impair prospects for growth and employment? In terms of social science research, what political, economic and social factors determine whether or not structural reforms are implemented in European countries?

To contribute to the understanding of of structural reform trajectories in Europe, this PhD project puts forward three academic papers on the political economy of structural reforms in Europe. In doing so, it faces the challenge that previous political economy research on structural reforms has overwhelmingly been conducted separately in the social sciences, particularly by economists and political scientists. In fact, political economy is no clearly bounded discipline, but the label given to research on the interface between politics and economics in different social science disciplines.[7] Consequently, the

[5] It is argued that in Europe's monetary union – in which competitive currency devaluation is no longer possible – competitiveness and by implication supply-side structural reforms, particularly of the labour market regulation, are particularly important (ECB 2011, OECD 2012).

[6] *State of the Union 2012 Address* to the European Parliament, European Commission President José Manuel Durão Barosso, Strasbourg, 12 September 2012, `http://europa.eu/rapid/press-release_SPEECH-12-596_en.htm` (retrieved 16.01.2013 17:35)

[7] Political economy research is the study of a 'political economy'. Given that the word 'political' denotes 'relating to the body of citizens or state, [...] a political economy, therefore, is a particular kind of economy. In the literal meaning of the words it is that kind of economy which has relation to the community or state [...].' (George 2006, 55-56) The classic political economy of Adam Smith, Stuart Mill, John Maynard Keynes or Karl Marx is widely understood to be the study of the effect of public policy on economic and social welfare. In this tradition, researchers in political science have continued to emphasise political and market institutions, and political and market power in their analyses (Hall 1997).

political economy of structural reforms is generally not an interdisciplinary but a multidisciplinary field of research, consisting of research contributions from economics and political science, each with their own, non-overlapping scientific discourses. The three papers of this PhD project build on contributions from both economics and political science, leveraging the analytical tools of both disciplines and drawing on the respective empirical insights.

The three papers are distinct, stand-alone contributions, each addressing different – though closely related – empirical puzzles. They employ different definitions and research methods, produce slightly different results, and speak to different strands of the political economy literatures. Nonetheless, all three papers point to similar findings: In many continental European countries, neo-corporatist structures and their influence both on the political and economic regime decisively affect structural reform policies and explain diverging reform trajectories to a significant degree.

The following introduction – together with the conclusion – provides a contextual framework for the three papers. More specifically, the introduction broadly reviews economic and political science contributions on the political economy of structural reforms, providing a sound theoretical and empirical base on which to build interdisciplinary research.[8] Section 2 critically reviews the groundwork of the contributions, critically discussing differences in the construction of the empirical puzzle, in the conceptualisation of institutions, and in the definition of 'structural reforms', and drawing lessons for the PhD project. Section 3 summarises – in very general terms – the theoretical and empirical findings of the literatures. It argues that the conventional determinants for structural reforms – socio-economic conditions, government partisanship, electoral pressures and veto powers – do not provide satisfactory explanations for the reform trajectories observed in Europe. Section 4 discusses the findings

Economists have defined political economy or – in delineation to classic political economy – 'new political economy' as 'the methodology of economics applied to the analysis of political behaviour and institutions' (Weingast & Wittman 2006, 3), that is, the transfer rational choice assumptions and game theoretic insights from market agents to political actors. Taking a broad approach that is impartial to the methodology chosen, political economy is here defined as the study of society as a complex system of political, economic and social institutions and conditions. Political economy thus necessarily takes an interdisciplinary approach and draws upon political science, economics, sociology and law, where appropriate, to further the understanding of social phenomena.

[8] The discussion of the literature in this introduction will take a 'birds-eye view', given that each of the three papers of the research project will include a more targeted literature review. Also, given the vast number of contributions that are directly or indirectly relevant to the understanding of the political economy of structural reforms, spanning several social science literatures, this literature review makes no claim to completeness. Rather it singles out exemplary, prominent contributions.

of the literature on institutional change in countries with neo-corporatist interest representation, arguably one of the most distinctive characteristics of many continental European countries. Section 5 concludes with a short summary of the main findings of the literature review and an outlook onto the three papers of the PhD project.

1.2 Questions and definitions

This section discusses research questions and definitions in the literature on the political economy of structural reforms. There is, however, no one literature on the political economy of structural reforms. Political economy research on structural reforms – and more specifically, the question under which economic, political and social conditions reforms are more or less likely to be implemented – developed in economics and political science in parallel.

On the one hand, the systematic analysis of determinants of structural reform in the economics literature is relatively young, growing in the context of the implementation of the Washington Consensus in developing and transition countries (Müller 2003, 11). Accordingly, the majority of early empirical literature focuses on Latin American and other emerging economies (Haggard & Webb 1993), with contributions addressing the political economy of reform in OECD countries following later (Williamson 1994b, Laban & Sturzenegger 1994, Krueger 2000). Theoretical contributions by economists develop formal, rational choice models of strategic interaction drawing on the insights of game theory to explain socio-economic policy outcomes, including structural reforms (Drazen 2000, for a summary of the early seminal contributions of this literature).[9]

On the other hand, political science is inherently more concerned with the

[9] The literature has been termed 'economic theory of politics' (Downs 1957) 'public choice' (Buchanan & Tullock 1962, Mueller 2003), 'political economics' (Persson & Tabellini 2000), 'public choice institutionalism' (Shepsle 2006) or 'new political economy' (Besley 2007), each of which may have a slightly different meaning. For example, 'public choice' and 'political economics' typically have slightly different sets of assumptions (Blankart & Koester 2006). In contrast to classic economics, this approach 'focuses less on picking good policies *per se*, and more on picking institutions apt to implement and sustain good policies.' (Besley 2007, F571, emphasis in original) A much-cited work on structural reforms includes, for example, the 'war of attrition' model by Alesina and Drazen, which shows how uncertainty over the distribution of costs and benefits of fiscal consolidation can lead to a delay in welfare-improving policy reform (Alesina & Drazen 1991). Some of these models have subsequently also been tested empirically. For example, Alesina et al. (2006) develop testable implications for the 'war of attrition' model and attempt to empirically confirm their theoretic insights.

description and analysis of political institutions and processes than economics. However, the discipline has long had 'much more to say about institutional effects than about institutional origins and change.' (Pierson 2000, 476) It is probably safe to say that the emergence of contemporary political science research on structural reforms in Europe is closely related to the first wave of welfare state retrenchment in the aftermath of the first oil crises in the 1980s. From this starting point, political science has produced a wealth of empirical research on the political economy of structural reforms, typically taking the form of case or comparative studies. Today, there are country case studies more or less explicitly addressing the issue of institutional change for almost every OECD country.[10]

In spite of some recent methodological convergence, however, political economy remains – regrettably – a multidisciplinary field, with few overlaps in the academic discourse between economics and political science.[11] Accordingly, the literatures differ in terms of the construction of the empirical puzzle on structural reform trajectories in Europe, in terms of their conceptualisation of institutions and institutional change as well as in terms of their definition of a 'structural reforms'. To provide a sound theoretical basis for the three papers of the PhD project, the following subsections critically discuss these differences and – where possible – develop a synthesis approach.

[10] There are political economy case studies of Germany (Katzenstein 1987, Kitschelt & Streeck 2004, Zohlnhöfer 2007, Streeck 2009, Hassel & Schiller 2010, and others), Sweden (Lindbeck 1997, Lindvall & Sebring 2005, Rojas 2005, and others), Italy (Ginsborg 2003, and others), France (Hancké 2002, and others), the United Kingdom (Howell 2005, and others) and the United States (Pierson & Skocpol 2007, and others), to name just a few. The comparative politics literature has also contributed to the understanding of structural reforms in different policy areas by contrasting institutional stability and change across countries and across time. Comparative research work has been done on labour market reform (Esping-Andersen & Regini 2000, Wood 2001), pension reforms (Bonoli 2000, Myles & Pierson 2001, Natali & Rhodes 2004, Häusermann 2010), vocational training reform (Anderson & Hassel 2008), industrial relations reform (Traxler et al. 2001), health care reform (Hacker 1999) and many other policy fields.

[11] It should be noted that the increasing use of the rational choice assumption and sophisticated quantitative tools – previously the domain of economists – in political science is blurring the boundaries of this discipline to economics in terms of methodology (Hall 2007). In addition, an increasing number of contributions from economics are resorting to analytical tools such as descriptive 'narratives' (Bates et al. 1998, Rodrik 2003), previously used predominantly by political scientists. For example, Boeri et al. (2006) provide case studies on reforms of the telecommunication, energy and electricity sectors to derive answers to the questions on how best to introduce structural reform. Many of the contemporary contributions are thus attributable to the economics or political science literature more on the grounds of department affiliation of their authors or the journal titles in which they are published than on the grounds of the methods used.

The empirical puzzle on structural reforms in Europe

A striking difference between the economics and political science literatures on the political economy of structural reforms is the construction of the research question, namely whether the absence or the presence of structural reforms is considered to be puzzling.

Economists, in particular, are generally surprised by the political resilience against reform towards more market-oriented institutional structures in Europe. From their perspective it is bewildering why structural reform measures that are thought to improve the welfare of an economy, for example by enhancing growth and employment prospects, are not implemented or, at least, not implemented more quickly (Williamson 1994b, Heinemann 2004). Already in the early 1990s, Fernandez & Rodrik (1991, 1146) identified this puzzle as one of the fundamental problems of political economy: 'Why do governments so often fail to adopt policies that economists consider to be efficiency-enhancing?'

This formulation of the puzzle on the political economy of structural reforms in Europe has two important problems: First, it requires a strong normative assumption about the desirability of liberal market reform, which certainly not all social scientists subscribe to (Crouch & Streeck 1997, Rodrik 2006, Amable et al. 2009, Armingeon & Baccaro 2012, Hall 2012). With its welfare-maximising perspective of socio-economic institutions, classic economics seeks to explain the persistence of welfare inferior institutions in European countries.[12] Second, a negative, blanket assessment of the structural reform efforts in Europe does not hold up under scrutiny. Particularly the negative overall assessment of the Lisbon Agenda too easily obscures significant variation in the reform trajectories among continental EU countries.

Although none of the continental western European countries followed the prescriptions of the Washington Consensus, at least four stylised reform trajectories can be identified: A first group of European countries adapted their economies relatively early and subsequently carried forward reform policies through the following decades successfully. Sweden, together with other Scandinavian countries, for example, implemented quite far-reaching labour market and welfare system reforms already in the mid-1990s, but remained at the top

[12] In this context, it should be note that – even taking a non-normative approach – the absence of reform in continental European economies can be construed also as a puzzle, as done in the previous introductory section: The observation that all European governments have a longstanding commitment to liberal market reform raises the question as to why the continental Western European economies have not followed the Anglo-Saxon economies in implementing more far-reaching liberal-market reforms.

of the so-called 'Lisbon league tables' for most of the early 2000s.[13] A second sample of countries implemented structural reforms late, living through extended periods of low growth and high unemployment without attempting any significant institutional changes. Germany, for example, was known as the 'sick man of Europe' through much of the 1990s. However, since the early 2000s Germany has been able to paradigmatically reform central elements of its welfare and labour market institutions. More recently, the German economy has experienced higher growth rates and decreasing levels of unemployment, referred to as the second German *Wirtschaftswunder* by some.[14] A third group of countries took measures to adapt the institutional structure of their economies early, but subsequently introduced no further reforms, in spite of low growth and high unemployment. Italy, for example, implemented fiscal, labour market and pension reforms in the 1990s. At the turn of the millennium, Paul Pierson found that, in terms of welfare state reforms, 'Italy [is] deserving [of] the second prize', runner-up only to the Netherlands (Pierson 2001b, 448). Ten years later, however, this assessment no longer holds. Through the early 2000s, Italy is recurrently listed among the worst performers in the Lisbon league tables and has inherited the title of 'sick man of Europe' from Germany.[15] The country had the lowest average growth rate of all EU-27 countries over the past decade, with just 0.3 percent.[16] Fourth and finally, some of the Mediterranean countries, in particular, did not at all significantly adapted their institutional structures before the onset of the global financial and economic crisis in 2007. In the Lisbon league tables, for example, Greece and Portugal have regularly been singled out as particularly bad performers.

The implementation of significant structural reform policies in a majority of European countries, in turn, typically presents a puzzle to political scientists. Political science has been defined as the study of the 'constraints to the use of social power' (Goodin 2011, 5). In this Weberian understanding of political decision-making, policies are determined by the relations between

[13] In order to facilitate reforms by peer pressure – one of the mechanisms aimed at encouraging reform by means of the 'Open Method of Coordination' (Zeitlin & Pochet 2005) – several academics and non-governmental organisation published rankings of reform success of the EU countries. The Centre for Economic Reform published ten 'Lisbon Scorecards' from 2001 to 2010, in which it tracked the reform progress of the EU member states (Bannerman 2001, 2002, Murray 2003, 2004, Murray & Wanlin 2005, Wanlin 2006, Barysch et al. 2007, 2008, Whyte & Tilford 2009, 2010). For other, technically more sophisticated league tables, see Blanke et al. (2008), Ioannou et al. (2008).

[14] Germany's rebounding economy, The Economist, 4 January 2007.

[15] The real sick man of Europe, in The Economist, 19 May 2005.

[16] Data Source: Own calculations based on OECD World Economic Outlook 2011

various groups or actors that share political power. Because the allocation of power within a political system is a zero-sum game, there is a good chance that an impulse to change the status quo by a power-yielding political actor will be constrained by countervailing political powers. Even if structural reforms are widely thought to enhance social welfare, political scientists would *a priori* not expect these to be universally implemented.

This is particularly true for many of the West European countries. When compared with other industrialised democracies, a relatively large number of political actors – parliamentary groups in a coalition government, second chambers of parliament, powerful interest groups, sub-national entities (i.e. federal states), constitutional courts, supranational bodies (i.e. the European Union institutions) – share power with the government. Countries are left with 'very modest capacities for restructuring' (Pierson 2001a, 448). This conventional wisdom in political science, however, stands in puzzling contrast to the observation that continental European countries that were long held to be particularly resilient towards structural reforms – such as Germany, Austria and the Netherlands – underwent significant institutional change.

The findings on the construction of the empirical puzzle on structural reform trajectories in Europe have two important implications for this PhD project: First, political economy research should avoid a normative approach to structural reforms in the construction of their research puzzle. Rather, following a more positivist approach, it should pursue questions resulting from empirical observations that contradict conventional empirical or theoretical wisdom. Accordingly, the papers of this PhD project – with the exception of a welfare analysis in Paper Two – remain broadly agnostic on the question whether deregulatory or (re-)regulatory supply-side reforms are desirable from a social welfare perspective.

Second, the above analysis of reform trajectories points towards the persistence of episodes of institutional stability and change in most of the continental European countries. Rather than a theory of institutional stability or institutional change by itself, political economy research should contribute to explaining both episodes of inertia and instances of reform to progress the understanding of structural reform trajectories in Europe.

Institutions and institutional change

The social sciences lack a single definition of institutions (Rhodes et al. 2008, xiii). Economics, political science and sociology have developed several distinct approaches to thinking about institutions, including 'historical institutionalism', 'rational choice institutionalism', 'organisational' or 'sociological institutionalism', 'discursive institutionalism' and possibly several more. There is a vast and ongoing debate on the advantages and shortcomings, delineations and the possible reconciliation of the different strands of institutionalism (Hall & Taylor 1996, Thelen 1999, Reich 2000, Steinmo 2001, Campbell & Pedersen 2001, Campbell 2004, Peters 2005, Hall 2007, and many more). In the following brief discussion of the conceptualisation of institutional change, the focus will be on historical and rational choice institutionalism, arguably the two approaches to institutions most prominent in economics and political science.

Historical institutionalism defines institutions as 'the formal or informal procedures, routines, norms and conventions embedded in the organizational structure of the polity or political economy' (Hall & Taylor 1996, 938).[17] Central to the paradigm of historical institutionalism is the understanding that current and future individual or policy choices are determined by historically established institutions or former choices (Steinmo et al. 1992, Thelen 2004, Hall 2008, and others); that 'history is not a chain of independent events' (Steinmo 2008, 166). Quasi by its nature, historical institutionalists did not conventionally emphasise institutional change, but gave substantial weight to the sequence of events and the concept of 'path dependency'. Existing policy arrangements are in place particularly because institutions tend to be self-reinforcing, that is, changing the institution entails switching costs (Pierson 2000). A plausible example – predominantly in common law systems – would be past court rulings that bind all subsequent court rulings (so-called 'precedential constraint').

How then is institutional change understood in historical institutionalism? What drives institutional change? To account for institutional change, researchers have conventionally resorted to the concept of 'critical junctures', at which point in time institutions are launched or amended.[18] On such occasions, political conflict emerges as the appropriate response to the calamity. Following closely the political science paradigm, institutions are then formed or re-formed depending on the prevailing power relations (Knight 1992). For example, in the early 1960s, existing laws and court rulings (path dependent

[17] In other words, institutions are sanction-enforced rules and regulations ('formal institutions') as well as non-codified constraints on the behaviour of individuals or groups within society ('informal institutions') (Amable & Palombarini 2008).

[18] Critical junctures may be understood as windows of opportunity that open up particularly due to social, political or economic upheaval, for example a severe economic crisis (Gourevitch 1986).

institutions) on race segregation in the United States were challenged by the campaigns of the African-American civil rights movement and escalating race riots (the critical juncture). This led to a power struggle between political proponents and opponents of race segregation in Congress, which was ultimately decided by the opponents with the landmark Civil Rights Act of 1964 (institutional change), setting the US on a different institutional path (Lieberman 2005).

More recently, Streeck & Thelen (2005) provided a much-noted critique of this conventional approach to explaining institutional change, which allows only for long periods of institutional continuity and isolated instances of change at critical junctures. Rather than static institutions that sporadically experience ruptures, as conventional historical institutionalism would hold, political actors continuously redefine institutions to accommodate changing requirements. Often these adjustments take place without significant political conflict or public debate. These mechanisms allow for a process of 'incremental change with transformative results' (Streeck & Thelen 2005, 9, Mahoney & Thelen 2010).[19] The concept of gradual, transformative change within the framework of historical institutionalism is an important addition to the conventional, overly static critical juncture approach.

Turning to the rational choice approach to institutions: This concept of institutions builds strongly on the assumptions of microeconomic theory, emphasising – to varying degrees – strategic interaction between political actors, and political choices based on the balancing of costs and benefits with the aim of maximising personal welfare. In a minimalist interpretation, institutions are simply understood as pattern behaviours induced by strategic interaction. These behaviours are self-reinforcing because they induce a particular and recurring choice of each actor that maximises his or her payoffs, given his or her preferences and given the choices of all other actors. This implies, importantly, that institutions cannot be understood as existing separately from strategies and actions of individuals or their organisations (Calvert 1995, Aoki 2001).

An obvious empirical example for this type of institution is the 'mutually assured destruction' (MAD) between NATO and the Soviet Union, guaranteeing the annihilation of both the attacker and the defender and thus deterring

[19] Case studies have described institutional change as a gradual process rather than abrupt political incident. For example, Myles and Pierson show how European pension systems responded to the challenge of fiscal austerity in the 1990s (Myles & Pierson 2001). Strongly predetermined by their historically-grown institutional setup, the European pension system did not fundamentally change – for example by switching from a pay-as-you-go to a funded system – but rather underwent adjustments within their respective systems.

any military offensive. This was a stable, self-reinforcing and informal institutional arrangement. In very abstract terms, practically all institutions can be conceptualised as 'equilibrium ways of doing things' (Shepsle 2006, 23).[20] Clearly, however, this approach disallows for any historical considerations.[21] Unsurprisingly, the rational choice approach to institutions has been criticised for being overly functionalist and 'a-historical' (Greve 2006, 368).

What does this imply for institutional change and the determinants of institutional change? Institutional change can be understood in the same way as a deviation from a Nash equilibrium. For this to happen, the payoffs and/or the preferences of one or more of the actors have to change. For payoffs and/or preferences to change it will typically require an exogenous shock. For example, mutually assured destruction was abandoned after the economic collapse of socialism in Eastern Europe and Russia and the end of the (perceived) reciprocal threat to each other's socio-economic system. Similar to 'critical junctures' in historical institutionalism, significant upheaval will typically be necessary to shift payoffs and/or preferences in such a way that there is institutional change.[22]

In short, political science and economics have developed two, quasi-antithetic interpretations of institutions – as exogenously defined norms (historical institutionalism) and as endogenously defined, equilibrium behaviour (rational choice institutionalism) – emphasising 'structure' and 'agency' respectively.

Beyond these two interpretations, there is, however, a spectrum of descriptions of institutions that fall in between the two archetypes, borrowing both from historical and rational choice institutionalism. One prominent approach to institutions in the economics literature, commonly associated with Douglass North (Weingast 2002), interprets institutions as 'the rules of the game in a society or, more formally, the humanly-devised constraints that shape human

[20] Think of road traffic; traffic law typically dictates either right-hand or left-hand driving. However, this law could just as well be thought of as a Nash equilibrium, from which no motorist has a reasonable incentive to deviate. Formally, a pure-strategy Nash equilibrium is 'an action profile with the property that no single player can obtain a higher payoff by deviating unilaterally from this profile' (Darity 2008, 540).

[21] For example, this approach disallows considering the influence that British and continental traffic law had on traffic rules in their former colonies.

[22] Greif & Laitin (2004) present a model of endogenous institutional change. Using an infinitely-repeated game structure (see Paper Two for an application of a similar model), they show in an analytical narrative how gradual changes in the payoffs can lead to the collapse of an equilibrium and institutional change. More generally, these changes in payoffs can be thought of as new conditions, which are generated by the institutional structure itself and which may at some point 'overwhelm self-enforcing behaviour associated with it' (Greif & Laitin 2004, 634).

interaction.' (North 1990, 3) This approach has a strong emphasis on rational choice behaviour, that is, it focuses on how institutions shape human behaviour by providing incentives. Note, however, that institutions are here exogenous to the behaviour of actors. Subsequently, power relations are decisive for institutional change (North 1993). In this, the approach is closer to historical than to rational choice institutionalism.[23]

A second prominent hybrid approach is that of institutions as economic resources (Hall & Soskice 2001a). More specifically, this approach suggest that rather than being costly constraints on their scope of action, institutions are best seen as 'capital' that actors can use to maximise their utility. On the one hand, institutions here again are, *a priori*, exogenously given to the actors. On the other hand, however, given their quasi-functional character, these institutions will come under pressure to change when they fail to serve the interests of the actors: 'Where an institution fails to serve [...], it becomes fragile and susceptible to defection from its rules.' (Hall & Thelen 2009, 11) In its understanding of institutional change, the 'institutions as resources' approach is thus closer to archetypical rational choice institutionalism than historical institutionalism.

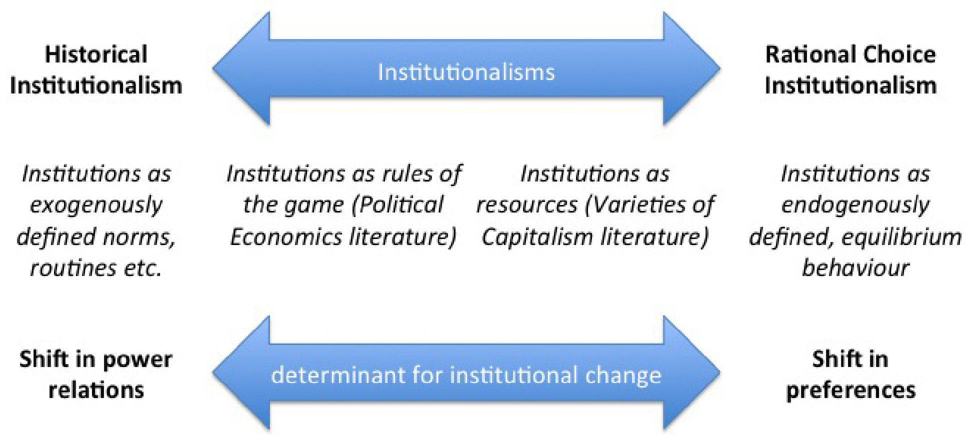

Figure 1.1: Institutionalisms and the associated determinants for institutional change

In summary, the political economy sets out to analyse institutional change with quite different understandings of the nature of institutions. Historical institutionalism emphasises the formal and binding character of institutions.

[23] Tellingly, North's concept of institutions as been claimed both by rational choice and historical institutionalists (Shepsle 2006, Ebbinghaus 2009, for example).

Rational choice institutionalism emphasises the societal consensus necessarily underlying a sustainable (set of) institutions. This divergent understanding of institutions also implies differences in the understanding of institutional change. Particularly, in the historical institutionalism tradition, institutional change is commonly associated with changes in power relations. In classic rational choice institutionalism, institutional change is associated more with the preferences of politico-economic actors (see Figure 1.1 on page 19).

The subsequent three papers of the PhD project follow different conceptualisations of institutions. While Paper 1 and Paper 3 broadly follow a historical institutionalist understanding of institutions, the model presented in Paper 2 conceptualises institutions squarely in the rational choice tradition. However, much care is taken to avoid letting the conceptualisation of institutions guides the understanding of institutional change. To varying degrees, all three papers take into account of changes in power relations and changes in institutional preferences – balancing structure and agency – to explain the absence and presence of structural reforms. A synthesis of the two conceptualisations of institutional change is attempted in the conclusion of the PhD project.

The concept of 'structural reforms'

Structural reforms are the object of analysis of this PhD project. Paper 1 analyses the coming about of the 'Agenda 2010' reforms in Germany in the early 2000s. The focus of the analytical narrative in Paper 2 is the labour market reform trajectory of Germany and Sweden in the 1990s and 2000s. Paper 3 focuses on instances of unemployment benefit system reform in the EU15 from the early 1980s to the mid-2000s.

These observations of structural reform policy share common features, that broadly fit the following definition:

> Structural reforms are enacted government policies intended to fundamentally change for the better the institutional structure governing a policy sector.

More specifically, five characteristics delineate structural reforms from other government policies: First, structural reforms are geared towards the institutional structure or 'institutional regime' (Streeck & Thelen 2005, 9-16) of (a policy sector in) a political economy. Heyse et al. (2006, 171) define reform as 'the fundamental, intended, and enforced change of the policy paradigm and/or organizational structure.' Reform, as such, can relate to government policy in general, or the organisational or institutional structure in particular.[24] ‘Policy reform’ thus is the broader concept, and refers to more or less paradigmatic changes in policies that do not necessarily affect the institutional regime directly. They may, for example, include shifts in government spending levels and priorities, foreign and development policy etc. ‘Structural reforms’, however, result from the implementation of policies specifically targeted to change the institutional structure or regime.[25]

To further underline this characteristic, it is useful to distinguish ‘structural reforms’ from ‘structural adjustment’, which is another closely related concept. Similar to ‘policy reform’, the term ‘structural adjustment’ is often used synonymously with ‘structural reforms’ in public policy and academic writing. Structural adjustment in the strict sense, however, is a technical term for a set of policy recommendations by the International Monetary Fund or the World Bank, the implementation of which is a condition for the provision of loans. In consequence, structural adjustment usually has two components, namely structural reforms and macroeconomic stabilisation.[26]

It should be noted that, in practice, it might not always be straightforward to disentangle structural from other socio-economic policies on the basis of just this one characteristic. For example, the switch from a growth- and employment-oriented to a price stability-oriented monetary policy clearly constitutes a paradigmatic policy reform. However, changing the mandate and organisation of a central bank to this end clearly constitutes a structural reform. Distinguishing between structural and other policies becomes increasingly difficult, the broader the concept of ‘institution’ is defined.[27]

Second, ‘structural reforms’ imply the conscious *ex ante* intent to change the institutional structure rather than change as the result of other, incidental exogenous developments or unintended secondary effect of other policy measures. Structural reforms are thus understood to be the result of active policy measures targeted towards the institutional framework of the political economy. This sets the concept apart from the broader, more passive concept of ‘institutional change’. Institutional change may come about by means of the

[24] Note that ‘reform’ is a transitive verb that requires one or more objects to form a meaningful sentence with it.

[25] In a much quoted contribution, Visser & Hemerijck (1997) similarly distinguish between changes to the rules of the game and changes in the goals and principles of policy.

[26] The latter are policy reforms to address severe internal and external economic imbalances, such as the inflation rate, balance of payments and public finances.

[27] For example, a growth- or inflation-oriented monetary policy may be considered an institution in itself.

implementation of structural reforms, but may just as well be the result of other, incidental socio-economic developments.[28] Additionally, policy changes that are not directly targeted towards the institutional framework of the political economy may nonetheless (indirectly) affect the same. These incidental or unintended institutional changes are, however, not understood to be structural reforms.

It should be noted, however, that unintended (and typically gradual) institutional change can have significant repercussions on structural reform policies. As the three papers of this PhD project demonstrate, non-deliberate change of the institutional structure of the political economy commonly induces political initiatives for structural reform. These institutional changes may come about due to exogenous factors. Paper 1 shows, for example, how the reunification of West and East Germany, together with progressing international economic integration, contributed to putting into question the German economic model in the 1990s. In this way, non-deliberate institutional changes may come about due to the unintended consequences of other socio-economic policies. In its analytical narrative of Sweden, for example, Paper 2 shows how wage compression undermined the functioning of the country's high-quality industrial regime and subsequently brought about structural reforms.

Third, the term 'reform' semantically always implies the *ex ante* intent of positive change. Structural reforms are intended to change the institutional regime towards improving socio-economic conditions, which are felt to be unsatisfactory in some way or another. That is, they are meant to improve economic growth, productivity (e.g. through education, and research and development), employment or work participation, fiscal sustainability, social or gender equality, and environmental sustainability etc. Again, this sets apart 'structural reforms' from 'institutional change'. Institutional change is the broader term, referring to an alteration of the institutional structure in general, and is *a priori* neutral regarding the welfare effects of the alteration to the institutional regime.

In this context, it should be noted that in the public policy and academic debate 'structural reforms' have long been used synonymously with supply-

[28] For example, when the Bismarckian old-age pension for citizens over the age of 65 was created in the late 19th century, it was only marginally relevant, given that life expectancy was below 45. With the drastic increase in life expectancy through the 20th century, the pension system has become one of the pillars of the modern welfare systems, accounting for 12.5 percent of GDP in the EU by the turn of the last century. Data source: EUROSTAT Main Economic Indicators

side reforms; market deregulation and welfare state retrenchment.[29] Alesina et al. (2008, 1), for example, defines structural reforms as the 'deregulation in the product markets and liberalization and deregulation in the labor markets.' Much of the political science literature follows similar definitions of structural reforms and focuses on the political economy of welfare state retrenchment (Pierson & Castles 2000, Pierson 2001b, Starke 2006, Palier 2010, among many others). This one-sided approach to structural reforms is easily accounted for by the long-lasting policy consensus on the liberal market paradigm described in the previous section.

However, it neglects the fact that structural reforms can in principle be deregulatory as well as (re-)regulatory. Political preferences for the former or latter may change over time, even within the same policy sector.[30] Structural reforms of financial market institutions provide a good example: Through the 1980s, 1990s and 2000s structural policies abolished market regulation with the aim 'to free up market forces and to promote long-term growth' (Lall 1995, 2020). Following the financial and economic crisis of the late 2000s, much effort is being put into re-regulating the same markets. The aim of these structural reforms is to 'control the forces that led the system to become absorbed with itself and ensure [...] that the financial system provides a sustainable contribution to economic growth'.[31]

Fourth, structural reforms are 'enacted' policies; institutional change for which political agreement was reached and/or for which legislation was passed. This simply implies that a policy aiming to change the institutional framework that is not successfully implemented – for example due to the resistance of opposition groups, due to the veto of a constitutional body in the legislative process or other macro-political factors – is not considered a structural reform.

[29] The IMF has defined 'structural reforms' as 'measures that, broadly speaking, change the institutional framework and constraints governing market behavior and outcomes.' (IMF 2004, 104) Similarly, Val Koromzay, Director at the OECD, defined structural reforms as 'changes in structural policy settings directed at improving static or dynamic resource allocation in the economy.' (in his contribution to the conference *Economic Reforms for Europe: Growth Opportunities in an Enlarged European Union*, Slovakia, 18 March 2004, `www.oecd.org/dataoecd/41/59/31506532.pdf`, retrieved 18.01.2013 16:35, quoted in OECD (2009, 16)).

[30] More recently, political economy research has taken a broader approach to structural reforms, taking into account that structural change does not necessarily imply the convergence towards a liberal market economy. Häusermann (2010, 8) argues, for example, that 'the main question is not just whether welfare states can be preserved, or whether they have to be radically dismantled. Rather, the challenge that social policy makers face today is a genuine adaptation of social protection to a profoundly altered economic and social context.'

[31] The ECB's response to the crisis, speech by Jean-Claude Trichet, President of the European Central Bank, Berlin, 26 May 2011

At the same time, enactment of a structural reforms does not imply the success of the policy. That is, the definition does not require a structural policy to achieve its intended goal of improving socio-economic conditions.

Fifth and finally, structural reforms change the institutional structure of a political economy in a fundamental way. In contrast to marginal adjustments to one or more institutions, structural reforms target the institutional regime of (a policy sector in) a political economy; the set of institutions that directs and shapes the behaviour of socio-economic actors. That is, structural reforms bring about paradigmatic rather than parametric institutional change. Returning to the example of monetary policy: A reform that provides a central bank with a price-stability mandate and makes it independent from political interference is clearly a paradigmatic change of the institutional regime. Changing the way central bank officials are appointed, while broadly preserving their independence, would have to be considered as a parametric adjustment rather than a structural reform of the institutional regime. In the seminal taxonomy of policy change put forward by Hall (1993), structural reforms are thus necessarily 'third order policy changes':

> 'First and second order change can be seen as [...] a process that adjusts policy without challenging the overall terms of a given policy paradigm [...]. Third order change, by contrast, is [...] marked by the radical changes in the overarching terms of policy discourse associated with a "paradigm shift".' (Hall 1993, 279).

The above, five characteristics of structural reforms set clearly the concept apart from institutional change as 'the result from an accumulation of gradual and incremental change', as described in the seminar contribution by Streeck & Thelen (2005, 19). More specifically, Streeck & Thelen (2005), Mahoney & Thelen (2010) and others argue that transformative institutional change may be the result of the slow rising salience of previously subordinate institutions *vis-à-vis* other institutions ('displacement'), the gradual change of existing institutions by attaching new elements ('layering'), the alteration of the scope, meaning and function of an institutions due to the change of its environment ('drift'), the redeployment of an institution for new purposes ('conversion') or the gradual breakdown of institutions over time ('exhaustion'). Indeed, many institutional transformations may take place according to these mechanisms.

The process of structural reform is, however, almost antithetic to the process of 'incremental change with transformative results'. While structural reforms are fundamental, intended, and formerly enacted, gradual institutional change is typically incremental, unintentional (in its socio-economic scope) and not necessarily subject to conventional legislative processes. Note, first, that while the cumulative effect of incremental adjustments may indeed paradigmatically change the institutional regime, *a priori* each individual incident of change is marginal in nature. Second, gradual institutional change happens with a significant degree of determinism.[32] This does not match the political purpose inherent in structural reform policies.

Accordingly, gradual institutional change is likely to follow a different logic of policy-making than structural reforms. macro-political factors – the electoral system, the legislative process, government centralisation, interest group representation etc. – are less likely to matter for gradual institutional change than for structural reforms. In many cases, incidents of incremental institutional change follow 'political skirmishing' over ambiguities of a technical or legal nature. While individual incidents of institutional change may be subject to political contestation, the transformative effect of the sum of the incidents of change is hardly appreciable by the political public. In contrast, politicians commonly adopted structural reform policies to demonstrate leadership. Their fundamental and deliberate nature is more likely to lead to broad public debate, and render their success or failure subject to macro-political factors.

While the mechanisms of gradual institutional change and structural reforms are different, there are – in principle – important links between marginal and structural institutional change. First, note should be taken of the non-linear nature of marginal institutional change. Generally, it is assumed that incremental change has transformative impact cumulatively. It should be noted, however, that small institutional adjustments unwittingly lead to 'structural breaks' and paradigmatic institutional change. For example, marginally adjustments may change the level of taxes or transfers beyond a threshold, inducing firms and households in a policy sector to fundamentally change their behaviour, and thus lead to a change in the institutional structure of the political economy. However, according to the above definition, this non-incremental institutional change is not a structural reform in the absence of political intent

[32] Streeck & Thelen (2005, 19) argue that 'significant change can emanate from inherent ambiguities and "gaps" that exist by design or emerge over time between formal institutions and their actual implementation and enforcement'. This implies that 'structure' precedes 'agency' by predefining institutions that become subject to change as well as the possible directions this change may take. Theories of gradual institutional change thus broadly continue to emphasise the importance of path dependency, arguing that 'institutional structure poses [...] a significant constraint on the degree and direction of change'. (Bonoli & Palier 2000, 334)

for fundamental institutional change.

Second, marginal institutional changes are commonly a precursor (rather than an element) of structural reforms. In this, structural reforms can again be interpreted as a special case of a 'third order policy change'. Insights on policy change and social learning put forward by Hall (1993) apply accordingly: Often policy makers attempt to address socio-economic problems with marginal adjustments to the institutional framework. Only if these policies are seen to fail, are more fundamental structural reform policies put forward. Paper 1 on the reform trajectory in Germany, for example, shows how successive governments attempted to 'fix' the institutional structure with marginal adjustments before the government of Gerhard Schröder decided to initiate more paradigmatic institutional changes.

1.3 Determinants of structural reforms

This section explores the determinants of structural reforms in the literature on the political economy of structural reforms. Given the multidisciplinary nature of the political economy of structural reforms literature, the following review of the political economy findings on the determinants of structural reforms will draw upon contributions from both political science and economics. It will discuss if and how far broad determinants for institutional stability and change identified in the literature help to explain the diverse structural reform trajectories in Europe, closing with an indication of an avenue for further research.

To begin with, however, the wealth of contributions from economics and political science raises the question of how to select and organise the literature's findings. In a modern democracy, structural reforms are, when implemented, the result of a policy process that starts with the emergence of a policy issue, typically followed by the formulation of alternative policy responses, subsequently followed by the deliberation of these alternative policies and ending with the selection of one of a policy for implementation. *A priori*, a multitude of factors can influence this policy process in any phase, determining for example whether a policy issue emerges in the first place and whether it leads to the change of the institutional status quo or not. In a somewhat stylised way, the findings of the literature can be attributing to different stages of the policy-making process (see Figure 1.2 on page 27).[33]

[33] Adopting a stage model of the policy process may be open to criticism, on the grounds

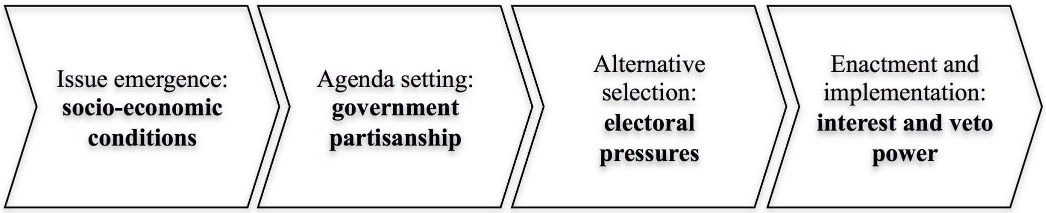

Figure 1.2: A reduced-form stages model of the policy process, following Birkland (2010)

In a reduced form of the model, four stages can be identified; the emergence of policy issues, the agenda setting, the selection of policy alternatives, and the enactment and implementation of the policy. At the first stage, we may expect that grievances with socio-economic environment would motivate policy initiatives. At the second stage, these grievances need to be translated into policy proposals. Among the most important determinants of how grievances are translated into policy proposals is government partisanship. Third, the electorate has an important role to play in the selection of policy options. At the fourth and final stage, the formal and informal political influence of actors may decide on the successful enactment and implementation of the new policy.

Determinants for the emergence of a policy issue: Socio-economic conditions

What determines whether or not the reform of an institution of a set of institutions becomes a policy issue? Broadly, it may be expected that pressures to reform institutional structures emerge if and when the status quo no longer seems to fit the requirements in a satisfactory way. Among the most widely discussed socio-economic developments that are thought to create pressures for industrialised countries to change their institutional structure are global-

that a stage model necessarily oversimplifies the policy-making process. It may be noted that the policy process is not a linear one and that certain factors influence the policy process at different stages. Nonetheless, the stylised stage model is ‘a remarkably helpful way to structure our thinking about the policy process’ (Birkland 2010, 26) and about the factors influencing its outcome.

isation[34], technological progress[35] and demographic change[36]. Put in a the shortest possible way, it is argued that increased international competition and new automation technologies have led to the displacement in particular of traditional manufacturing industries in Western European countries[37] This is putting many of the established institutions – in Europe, particularly the institutions of the welfare state – into question. For example, high and increasing levels of structural unemployment may put at disposition labour market regulation and unemployment benefits. At the same time, demographic developments towards an ageing population may increase pressures to change the health and pension elements of the welfare state.

However, on closer inspection, these macro-factors as such are of little explanatory value, particularly for the diverse reform trajectories in Europe. Technological progress, globalisation and demographic change broadly affect all European countries in the same way. For example, European Single Market and euro area membership – both movements towards closer international economic integration in Europe – are found to be significantly positively correlated to the propensity of European countries towards structural reform (Høj et al. 2006, Leiner-Killinger et al. 2007, Duval 2008). At the same, however, all continental European economies are part of the Single Market and most of them are also part of the euro area.

It could be argued that the macro-factors matter for the emergence of po-

[34] Globalisation, the term commonly used for the process of 'international economic integration' (Rodrik 2000), is exposing many economies to a new level of international competition, by adding more and more items to the list of internationally exchanged commodities (Sapir 2006) and allows for an 'easier flow of knowledge and information across borders.' (Heinemann 2006) Services, which were formerly not thought of as exposed to international competition, are also increasingly confronted with competition from other countries (Herman 2010).

[35] It has been argued that technical progress is changing the political economy into a 'post-industrial society' (Ritzer 2007). Added value was not primarily gained from the production of goods, but more and more through the service industry. Productivity gains resulted more from better academic or creative abilities than through more productive manual labour. Blue-collar jobs were being lost and replaced by job-openings for white-collar staff.

[36] Many industrialised economies are facing huge demographic changes on several accounts. Higher income and the invention of birth control have left many European societies with a skewed population age structure, with disproportionately few young and working people and relatively many elderly and retired people. Additionally, the formerly relatively homogeneous societies have found it difficult to integrate a substantial influx of immigrants into their societies and economies. These demographic changes are said not only put substantial strain on social security systems (Feldstein 2005), but also create shortages of skilled labour for Europe's economies that specialised on technologically sophisticated products and services.

[37] For an account of the effect of globalisation, for example, on institutional change, see Schwartz (2001), Djelic & Quack (2003), Campbell (2004).

litical pressures to change the institutional status quo only in as far as they lead to socio-economic crisis, negative economic growth and fast growing unemployment, for example. Indeed, one the most robust findings of the political economy literature is evidence for the 'crisis hypothesis'. The hypothesis states that severe economic downturns encourage reform. Already in 1995, Tommasi & Velasco (1996, 13) establish 'that economic crisis seems either to facilitate or outright cause economic reforms is part of the new conventional wisdom on reform'. Targeted quantitative empirical studies show that the crisis hypothesis holds across countries and time (Drazen & Easterly 2001, Pitlik & Wirth 2003). With different emphasis and restrictions, broader quantitative empirical studies also seem to confirm this finding (IMF 2004, Høj et al. 2006, Duval 2008, Alesina et al. 2006), making the crisis hypothesis the strongest finding of quantitative investigations into the determinants of structural reform.[38]

However, the crisis hypothesis – at least by itself – also falls short of explaining the reform trajectories in continental Europe. While paradigmatic structural reform may indeed be commonly preceded by economic crisis – also in European countries – many of the same countries remain complacent even in the face of periods of low economic performance or even severe economic crises. Italy is a particularly striking example. While the country had a higher real per capital income than both France and the United Kingdom in the early 1990s, by 2007 it had fallen behind both of these countries.[39]

In summary, economic or social problems ('crises') – or the perception thereof – may indeed be an important – if not necessary – condition for reform. It can easily be shown, however, that an adverse macroeconomic environment is not a sufficient condition for reform.

Determinants for agenda setting: Government partisanship

Following the emergence of a salient political issue, pressures to change the institutional status quo need to be translated into policy proposals. With respect to socio-economic institutions, the policy alternative is commonly more

[38] Political economics models even show how crisis can be welfare improving if the subsequent reforms elevate the economy onto a higher growth path (Drazen & Grilli 1993, Hsieh 2000).

[39] Data Source: Own calculations based on OECD World Economic Outlook 2011. The 2008 Lisbon Scoreboard published by the Centre for European Reform finds that 'Italy is going to have to raise its game to avoid a further decline in its relative prosperity within the EU. It scores poorly on just about every [reform] indicator.' (Barysch et al. 2008, 11)

or less government involvement; more or less government expenditure, or more or less regulation of markets.

Conventionally, we expect left-leaning governments to hold on to more regulation and conservative governments to be more likely to implement liberalising reform. One interpretation of this anticipated behaviour is simply the expectation that world-view matters for socio-economic policy choice: the political left has a strong inherent preference for distributive justice, which requires government intervention and regulation. The conservative political camp's ideology emphasises property rights and individual freedom, and thus advocates government restraint and deregulation.[40]

Political partisanship can, however, also be understood as a distributional, social conflict. Building on the Marxist concept of social class, 'power resource theory' investigates the impact of relative power position on the interest representation of capital and labour (Stephens 1986). Policy outcomes, and particularly the level of redistribution in the welfare state – and arguably in reverse the level of welfare retrenchment – depend much on the relative power of the political left and organised labour (Bradley et al. 2003). According to this argument, on the one hand, conservative governments would generally be expected to cater to the interests of capital owners and pursue liberal market reforms, retrenching redistributive institutions. Labour governments, on the other hand, would be expected to pursue policies of market 'decommodification' and redistribution.

The results of quantitative empirical investigations into the effect of government partisanship on structural reforms are, however, inconclusive. Amable et al. (2006) finds that left-wing governments strengthen welfare institutions in the light of shocks, while conservative governments use economic downturns for welfare retrenchment. Other quantitative studies also support the conventional understanding that conservative governments are more inclined to liberal market reforms than left-wing governments (Allan & Scruggs 2004, IMF 2004, Alesina 2006, Duval 2008, for example). A second group of studies, however, finds no correlation between government ideology and welfare expenditure (Castles 1998, Belloc & Nicita 2011, for example). And a third group of studies even finds evidence of an inverse effect of ideology on welfare spending, by which conservative governments engage in less welfare retrenchment than

[40] In a slightly different line of argument, Prasad (2006) shows that the credibility problems of a particularly militant left in the United Kingdom and the United States created opportunities for conservative politicians to mobilise dissatisfaction with the status quo and introduce far-reaching liberal-market reforms.

left-leaning governments (Ross 2000, Høj et al. 2006, Green-Pedersen 2007, for example).[41]

This mixed evidence on the effect of government partisanship carries over also to the continental European reform trajectories of the past decades. Reforms have been implemented both by conservative governments in the United Kingdom and Sweden as well as by social-democratic governments in Germany and the Netherlands. All in all, the explanatory power of government partisanship on the reform propensity in Europe seems limited.

Determinants for policy selection: Electoral pressures and public opinion

In the selection of a policy alternative for implementation, a government ultimately relies on public support, not least because the reform may otherwise be reversed after its departure from power. However, one of the oldest assertions about the implementation of reform is that public opinion is generally opposed to change. Already in the 16th century, Niccolò Machiavelli found that reforming the institutional structure of a polity seldom finds majority support, introducing a status-quo bias into political systems.[42]

More specifically, Machiavelli posits that structural reforms are unpopular; first, because gathering support for reforms is difficult due to uncertainty regarding their effects, and because, second, those benefiting from the status quo will oppose reforms in any case. These claims have broadly been supported by contemporary research. With respect to the first claim, political economics contributions have shown how uncertainty over reform payoffs at individual level and the resulting popular opposition can lead to a status-quo bias or reform delay. In their seminal contribution, Fernandez & Rodrik (1991) show that – if no *ex post* transfers are possible between winners and losers of a reform

[41] Political economics has been able to capture the logic of this last finding in a formal model. Left-leaning governments may find it easier to introduce liberal reforms than conservative governments due to a 'Nixon-Goes-to-China' credibility problem (Cukierman & Tommasi 1998b,a). Another possible explanation for the inconsistent empirical results is the blur of the classic right-left dichotomy. In particular, the social-democratic 'marching to market' in the 1990s begs the question of how far the conventional understanding of partisanship remains an relevant policy determinant (Schelkle et al. 2010).

[42] 'It ought to be remembered that there is nothing more difficult to take in hand, more perilous to conduct, or more uncertain in its success, than to take the lead in the introduction of a new order of things. Because the innovator has for enemies all those who have done well under the old conditions, and lukewarm defenders in those who may do well under the new. This coolness arises [...] partly from the incredulity of men, who do not readily believe in new things until they have had a long experience of them.' (Niccolò Machiavelli, The Prince, Chapter 6, 1513)

– welfare-increasing reforms may not be introduced as much as expected, even if a majority of the population would gain from the reforms *ex post* (Laban & Sturzenegger 1994, for similar arguments).

With respect to the second claim, Pierson (2001a, 411) finds in his important contributions on welfare state reform that one of the sources of European welfare state stability is 'the electoral incentives associated with [welfare] programmes which retain broad and deep popular support' (Pierson 1994, for a similar argument). In other words, many of the welfare institutions of the 'European economic model' remain highly popular, while initiatives to cut back these institutions typically are not. This is not very surprising, taking into account that practically all reform proposals involve cutbacks in the social security systems or government transfers, from which – as Pierson (2001a) describes – an absolute majority of the population benefits. Given this opposition to reform, governments are thought to be disinclined to introduce reforms. Indeed, Jean-Claude Juncker, then Prime Minister of Luxembourg and President of the Eurogroup, famously said, 'We all know what to do, but we don't know how to get re-elected once we have done it.'[43]

However, empirical studies find no evidence for the so-called 'Juncker Curse', namely that voters punish governments for structural change by voting them out of office (Buti et al. 2009). To the contrary, recent empirical studies show, for example, that unsustainable fiscal policies generally reduce the probability of re-election (Brender & Drazen 2008, Drazen & Eslava 2010).[44] All in all, there is little coherent empirical evidence to corroborate the conventional wisdom held on popular discontent with reforms.

Determinants for policy enactment and implementation: Formal and informal veto power

Not all Policy initiatives by a government will be enacted and implemented. The reason for this is that governments in modern Western democracies typically do not hold absolute power over legislation and regulation. Rather, political power is shared with other actors in the political arena, who can more or less effectively prevent a departure from the institutional status quo. This veto power can generally have a formal or informal nature. That is, the veto-yielding

[43] Quoted in Bonfiglioli & Gancia (2011).

[44] In a recent theoretical contribution, Bonfiglioli & Gancia (2011) show that, under the realistic assumptions of asymmetric information between voters and the government, reformist governments are not necessarily punished by voters and uncertainty about the effects of reform can in fact foster reform policies.

political actors may have constitutionally or quasi-constitutionally enshrined powers in the policy-making process. Alternatively, the political actors may hold sway over the policy-making process in some other, informal way.

A first strand of literature – both in political science and economics – focuses on the impact of the formal constitutional order on policy outcomes.[45] The study of the impact of constitutional order on policy outcomes goes very much to the heart of the political science discipline. Classic contributions to this strand of literature are Lijphart's model of the majoritarian and consensual state, which describes the more inclusive nature of continental European states *vis-à-vis* Anglo-Saxon countries (Lijphart 1984), and Scharpf's 'joint decision trap' model, which describes how federally-organised states (or confederations such as the EU) are biased towards lowest common denominator policy decisions because of the sanctioning power of federal entities (Scharpf 1988). Similarly, the economics literature has contributed a large number of models on the effects of constitutional rules on socio-economic policy-making and performance, a significant number of which are presented and subsequently tested in the seminal contributions by (Persson & Tabellini 2000, 2001), for example.

An evident conjecture is that more diffused formal political power will reduce the ability of the government to change the regulatory status quo and will bias the polity towards the status quo. Indeed, IMF (2004) and Alesina et al. (2006) find that more powerful governments (majoritarian or presidential systems or unified governments with a large parliamentary majority) are more likely to implement reforms. However, the overall evidence from the quantitative research on the relevance of constitutional rules – such as the nature of the political system or the electoral system – for the reform propensity of industrialised countries is not as strong as expected. Høj et al. (2006), for example, find that the formal system of policy-making has no significant effect on structural reform policies.

A second strand of literature investigates the influence of informal interest groups on the policy-making process. Much of the rational choice literature on interest groups goes back to Olson's seminal contribution on the 'Rise and Decline of Nations', which describes how well-organised special interest groups can damage the broader economy (Olson 1982). This literature has developed

[45] It investigates, for example, the impact of regime-type (presidential or parliamentary), party system-type (one-, two- or more-party), parliament-type (unicameral or multi-cameral) and electoral system-type (proportional or majoritarian) on governments' policy-making ability.

sophisticated models on the impact of interest groups on political outcomes (Grossman & Helpman 2001).[46]

One of the most widely noted rational choice contributions on policy implementation is Tsebelis' Veto Player Model (Tsebelis 1995, 2002). The model abstracts from description and analysis of individual veto-yielding constitutional actors and interests groups and breaks down the complex research in the economic and political science literature to a simple question: which agents can potentially stop a departure from a political status quo? Its intuitive simplicity makes the veto player framework an attractive framework in which to explain policy continuity and change. Unsurprisingly, the model has been widely used to investigate reform inertia (Hellman 1998, Bawn 1999, Bonoli 2000, 2001, Merkel 2003, Gehlbach & Malesky 2008, Däubler 2008, and others). In general, however the model seems to be more suited to explain institutional stability than institutional change.[47]

Quasi in response to the status quo bias in veto player theory, recent contributions have combined the veto play model with coalitional analysis. More specifically, researchers emphasise the importance of political coalitions between veto-yielding political actors to establish and change institutional arrangements (Dur & Swank 1998). Häusermann (2010), for example, presents a study of pension reforms in France, Germany and Switzerland between 1970 and 2005.[48] There are, however, both theoretical as well as empirical limitations to this approach. First, coalitional models risk rationalising policy outcomes with coalitional shifts. Particularly if a large number of explanatory factors are included in the analysis – such as 'structure, institutions and actors' preferences and strategies' (Häusermann 2010, 9) – coalitional analysis risks

[46] To name an example, Faure-Grimaud & Martimort (2003) presents a model how asymmetric information between a representative government and the governmental bureaucracy can lead to policies that favour the bureaucracy and institutional stability rather than the electorate and institutional change.

[47] The ingenious simplicity of the Veto Player Model, however, also has its drawbacks. It takes the interests of veto players as given and fixed. Policy change is thus only possible within the joint 'winset' of all veto players. Assuming rational actors implies, however, that this winset will be exploited within a relatively short period of time. What happens thereafter when no further Pareto improvement is possible? In this case, policy change is only possible following a shift of the relative position of veto players within the spatial policy plane, that is, change of their preferences. However, the veto player model cannot address the question of what shapes, and thus what changes, the preferences of the veto players. see Paper 1 of the PhD project for a more detailed discussion of the Veto Player Model

[48] The comparative study shows how shifting coalitions due to changes in the socio-economic environment and a form of legislative logrolling allow for structural reform even in political systems with a large number of veto players (Häusermann 2010, 115). Modelling institutional change as 'coalitional engineering' provides a compelling argument and is an important contribution to the political economy of structural reform literature.

being over-determined. Second, in many empirical cases of structural reforms there is no evidence of the 'coalitional engineering'. For example, the 2003 Agenda 2010 reforms in Germany cannot be explained by the development of new cross-class coalitions (see Paper One of this PhD project).

Besides the rational choice approach on interest group and veto power, there is also a historical institutionalist tradition on interest group research, particularly on Europe. The research on the influence of interest groups in European political economies is commonly linked to the study of 'corporatism' (McFarland 2010). The field of research has developed a rich literature, its origins reaching back to the 1960s (Shonfield 1965, Schmitter 1974, Schmitter & Lehmbruch 1979, Katzenstein 1985, Schmitter 1989, and many others). Corporatism captures a form of interest representation – 'networks linking government with [centrally-organised] interest organizations, many of which have quasi-public status as key actors in policy making' (Molina & Rhodes 2002, 305) – that is of particular importance to many countries in Europe. This warrants a closer look at what the literature has to say about its influence on institutional stability and change in the following section.

1.4 Structural reforms and neo-corporatism

The following section discusses the relationship between structural reforms and neo-corporatism in the literature on the political economy of structural reforms. Corporatism – or, more precisely, 'neo-corporatism' – is one of the most thoroughly studied concepts in the research of Western Europe.[49] Nonetheless (or maybe for this very reason), the concept remains very broad. Depending on the field of research, it carries different connotations (Almond 1983, Molina & Rhodes 2002). With some stylisation, two strands of literature can be distinguished; one democracy theory school and a second school on political economy, both of which have produced a large number of contributions. On the one hand, the democracy theory literature analyses corporatism as a system of interest representation and a process of democratic policy making. On the other hand, the political economy literature on corporatism focuses on the organisation of economic interests, their interplay with government institutions

[49] 'Corporatism' is today commonly used synonymously with the more accurate term 'neo-corporatism'. The term 'corporatism' or 'corporativism' is linked to the fascist economic ideology of Benito Mussolini. Further, 'neo-corporatism' has to be distinguished from 'state corporatism', in which cooperation is state-enforced, while neo-corporatism is based on interaction between government and interests groups on more equal terms.

and their impact on macro-economic outcomes such as inflation, growth and employment. The two strands vary more in the focus of their study than in their principle understanding of corporatism. Somewhat surprisingly, however, they come to almost contrary conclusions on the predicted effect of corporatism on structural reform.

Within the democracy theory school, corporatism is commonly seen as integral part of a form of government with defused political power. In his famous conceptualisation of different types of democracy, Lijphart (1984, 1999) ranks the political rules and practices on a scale from 'majoritarian democracy' at the one end and 'consensus democracy' at the other end. To varying degrees, many European democracies share features of a consensus democracy: 'executive power sharing in broad multiparty coalitions, executive-legislative balance of power, multi-party systems, proportional representation, and coordinated and "corporatist" interest group systems aimed at compromise and concertation.' (Lijphart 2008, 7)

Based on the concept of 'consensus democracy', authors attribute considerable political power to the corporatist interest groups. Accordingly, so the argument goes, corporatist interest groups can effectively prevent a change to the status quo (Bonoli & Palier 2000).

> [T]he character of the interest group system, especially the degree to which the system is social corporatist, should facilitate the extent to which affected actors can press their claims against adverse policy changes in the face of fiscal stress and internationalization. [In consequence,] social policy change in such an environment will typically involve slow, marginal, negotiated changes in which all interests are accounted; relatively quick and non-trivial retrenchments of the welfare state in response to domestic pressures and internationalization are unlikely. (Swank 2001, 208-209)

In line with this argument, much of the quantitative empirical literature accepts corporatism as an institutional arrangement, by which veto points are added to the policy-making process. Authors thus anticipate that countries with stronger corporatist features are more resistant to welfare retrenchment: Allan & Scruggs (2004, 504), for example, 'expect more integrated/corporatist democracies to be more resistant to welfare state retrenchment'. To their own surprise, most authors – investigating the more direct effect of corporatism on the propensity to reform – do not obtain robust evidence for an effect of corporatism on reform propensity. Høj et al. (2006, 23) writes: 'Somewhat surprisingly, no robust evidence was found concerning the effects of bargaining systems and industrial relations [...] on the propensity to implement structural reforms.' (Helbling et al. 2004, Allan & Scruggs 2004, for similar findings)

The failure of empirical studies to produce significant results on the relationship between corporatism and structural reforms is likely related to the oversimplifying assumption that corporatist actors – as veto players – generally block reform. While it may generally be assumed that a system with more veto players increases the likelihood of a status quo bias, it is not *a priori* clear that corporatist actors have an inhibiting effect on structural reforms.

In fact, the political economy literature on corporatism broadly comes to the opposite conclusion of the political theorists. Here, corporatism is understood primarily as an arrangement by which originally antagonist interest groups – such as employer organisations and trade unions – cooperate to pursue common interests. In this way, concertation among governments, trade unions and employer organisations in tripartite fora can facilitate competitive wage setting, but also labour market and welfare reforms (Hassel 2003, Natali & Rhodes 2004, Hancké & Rhodes 2004, Simoni 2010). Ebbinghaus & Hassel (2000, 45) find that 'concerted reform built on a consensus of governments, employers and unions can be crucial [...] in overcoming potential blocks against reforms'. In her study of pension reform in Europe, Häusermann (2010, 268) goes even further when arguing that 'countries with a tradition of consensus politics and negotiation may have a comparative advantage. Thereby, a high number of veto points (i.e. a high number of power-sharing institutions) may turn from an obstacle to an asset for a country's reform capacity.'

While they reach different conclusions on the impact of corporatism on structural reform policies, most of the political theory and the political economy literature on corporatism describe corporatist actors as political potent, with the power to obstruct institutional change.[50] Veto player theorists themselves, however, rejects this presumption outright. Tsebelis (1999, 603) altogether denies corporatist agents a veto-yielding role. '[L]egislation is produced whether the social partners agree or not. If they agree, then the parliament or the government issues legislation or decrees that confirm the agreement.

[50] Somewhat differently, Culpepper (2002, 774) argues that 'policy-makers lack the combination of technical, relational, and local information necessary to design successful blueprints for reform, and so they are dependent on the social partners to acquire this information'. While the social partners remain important partners in the reform process, their influence does not originate from veto power, but rather from an informational advantage.

If they disagree, then the legislative institutions of the country decide on the issue.' Gourevitch & Hawes (2002, 253) similarly argue: 'Corporatism is created by political process. Political systems decide who gets voice and in what way. The system of interest representation towards the government is an act of delegation by authorities to groups – an action which can be revoked. [...] The degree of corporatism is thus an expression of politics.' It is difficult to reject this critique of the corporatism literature outright. Corporatist actors typically have no constitutional powers, meaning that they are no veto players according to the Veto Player Model. Theoretically, a government with a legislative majority in parliament should indeed be able to dismiss the opposition of trade unions or employer organisations.

However, understanding corporatism as a purely optional policy-making forum – that may, in the best case, help governments muster a broader consensus for potentially controversial policy measures and, in other cases, may simply be swept aside – is also a misconception.[51] It is a decisive feature of corporatism that, while it does not add formal veto players to the political arena, it does provide selected societal interests with significant political influence. This political influence results from the close interlocking of formal and informal institutions, which provides corporatist agents with subtle, yet important political power. Even a weakening of formal corporatist structures, such as the reduced use of tripartite committees in policy formulation in many Scandinavian countries does not necessarily have to lead to a weakening of corporatism as such (Christiansen & Rommetvedt 1999).

In summary, corporatism is maybe best understood as 'institutional arrangements whereby important political-economic decisions are reached via negotiation between or in consultation with peak-level representatives of employees and employers (or other interest groups) and the state'. (Kenworthy 2003, 11) These 'institutional arrangements' can be described as the 'institutionalized and privileged integration of organized interests in the preparation and/or implementation of public policies'. (Christiansen et al. 2009, 26) However, how exactly these institutional arrangements – arguably one of the most

[51] In many ways, this account of corporatism is closer to the pluralist system of informal, *ad hoc* interest representation or lobbyism. 'Pluralism can be defined as a system of interest representation in which the constituent units are organized into an unspecified number of ordered multiple, voluntary, competitive, non hierarchically and self-determined (as to type or scope of interest) categories which are not created or specially licensed, recognized, subsidized, otherwise controlled in leadership selection or interest articulation by the state and which do not exercise a monopoly of representational activity within their respective categories.' (Schmitter 1974, 95) However, a characteristic of corporatism is that constitutional policy-making bodies cannot easily ignore corporatist agents.

distinguishing characteristics of many continental European countries – impact structural reform policies, whether they obstruct or facilitate institutional change, remains contested.

This calls for more research on the political economy of structural reform in neo-corporatist countries, to which this PhD project will contribute three academic papers.

1.5 Summary and outlook

In the previous sections, this introduction to the PhD project provided a broad review of the literature on the political economy of structural reforms, developing insights for interdisciplinary research on structural reform trajectories in Europe. First, the discussion on the nature of the multidisciplinary literature revealed that previous contributions focused too narrowly on explaining either institutional stability or institutional change. An explanation of the diverse reform trajectories in Europe, however, requires understanding of both institutional stability in the presence of significant socio-economic pressure to adjust and institutional change in the presence of highly diffused political power in the European political systems.

Second, the discussion of the literature revealed that different conceptualisations of institutions in the stands of the literature have important repercussions for the findings on institutional change. More specifically, a historical institutionalist approach tends to emphasise the significance of power relations, while a rational choice institutionalist approach tends to accentuate the importance of preferences. To avoid a inadvertent bias towards the one or other determinant of structural reform, this implies that research on institutional stability and change has to take a conscious approach to assumptions made on the nature of institutions.

Third, the above provided a definition of structural reforms, namely as enacted government policies intended to fundamentally change for the better the institutional structure governing a policy sector. It argued that – while there may be important interlinkages – structural reforms are distinctly different from other forms of policy change, from other forms of (unintentional) institutional change, and from gradual institutional change with transformative results.

Fourth, the discussion of the central findings of previous contributions revealed that none of the conventional explanations – or at least none of the conventional explanations on their own – account for the reform trajectories observed in Europe. Reform trajectories of European countries demonstrate that socio-economic conditions and particularly economic crisis are not a sufficient condition for structural reform, although they may be a necessary one. Theoretical and empirical findings on government partisanship, electoral pressure and public option, and interest group and veto power on structural reforms remain inconclusive.

Fifth, the review of findings on the effects of corporatism – a form of interest representation of particular importance for many European countries in particular – on structural reforms revealed similarly inconclusive findings. While a democracy theory strand of the corporatism literature finds that this form of interest representation is likely to obstruct reform, a political economy strand of the literature argues that a tradition of consensual policy-making may in fact facilitate the implementation of structural reform policies. It was argued that the reason for this may be an incomplete understanding of corporatist interest representation in the political economy.

Building on these insights, this PhD project puts forward three political economy papers with the aim of contributing to the understanding of the determinants of structural reforms in European countries. the first paper is a case study, analysing the reform trajectory of one particular European political economy. More specifically, the Paper One – entitled **The Political Economy of the Agenda 2010 Reforms: How Gerhard Schröder Overcame the "Blocked Republic"** – explores the trajectory of welfare and labour market reforms in Germany from the early 1980s to the mid-2000s. It addresses the puzzle as to why the so-called 'Agenda 2010' – arguably the only noteworthy overhaul of the German socio-economic model since the Second World War – was undertaken in in the early 2000s and by the left-leaning government of Gerhard Schröder, not by the conservative governments that preceded it. Through the 1980s and 1990s Germany suffered from repeated growth crises, high and rising unemployment, and growing fiscal imbalances. In spite of two decades of persistent reform rhetoric of the conservative government of Helmut Kohl, however, no significant measures were taken.

The paper critically discusses the dominant analytical framework to analysis policy stability and change – namely the Veto Player Model – and puts forward an augmented veto player framework for the analysis of the German political economy. The paper subsequently compares four distinct episodes of the German political economy, namely the pre-reunification period of the

1980s, the post-reunification period of the 1990s, the first social-democratic government under Chancellor Schröder from 1998 to 2002, and the second social-democratic government of Chancellor Schröder from 2002 to 2005. It finds corporatist institutions, the multilevel governance structure and the lack of cohesion within the federal government alternately blocked reform in Germany between 1983 and 2002. Only in 2003, when the blocking power of all these constraints waned, was it possible for the federal government to implement far-reaching socio-economic reforms, the ‘Agenda 2010’.

Although the paper is written broadly in a historical institutionalist tradition, the first paper is that institutional stability and change – among other things – depends also on the interests of employer organisations and trade unions. The paper finds that structural reforms were possible after social partners started questioning the consensus on the economic model in which they operate. Based on this insight and the concept of institutional complementarity found in the Varieties of Capitalism literature (Hall & Soskice 2001b), the second paper – entitled **Corporatist cartels: Explaining reform inertia in continental European economies** – develops a model of a European ‘coordinated market economy’. More specifically, the paper shows how coordination between firms, trade unions and the government is used to shape a country’s comparative advantage in the global economy.

In contrast to the first paper, Paper 2 taking a distinctly rational choice approach to institutions. Institutional stability and change in this model depend on the change of the payoffs for corporatist actors. More specifically, an institutional structure will remain stable until the costs of coordination exceed its benefits for one or more of the coordinating actors. At this point, one or more actors will start defecting from the coordinating equilibrium and pressures to eliminate the coordinating institutions, that is, pressures to reform the political economy will arise. The second paper concludes with an analytical narrative of labour market reforms in Sweden in the early 1990s and in Germany in the early 2000s to illustrate the functioning of the model. It shows how rising costs and/or falling benefits from institutional status quo can account for the different reform paths.

The third paper, entitled **Corporatism, the game-changer: The intermediating effect of privileged interest representation on the determinants of labour market reform in Europe** investigates the impact of economic and political factors across a larger sample of corporatist and pluralist countries. First, it argues that changes institutional preferences of privileged corporatist interest groups should be reflected in changes in the probability of structural reforms in corporatist countries. Focussing on reforms to unemployment benefit system, both trade unions and employer organisations are more likely to pursue benefit retrenchment in 'bad times' than in 'good times'. In the absence of privileged interest representation, institutional preferences should not matter in pluralist countries. Second, the paper argues that conventional determinants for structural reforms – for example, government partisanship and economic crises – should be found to matter in pluralist countries, but not in corporatist countries.

Using a data on structural reforms, the paper sets out to test four hypotheses on structural reform determinants. Using an ordinal logistic regression model, the paper shows that probabilities for structural reforms indeed diverge across corporatist and pluralist countries. It concludes that the intermediating effect of corporatism has to necessarily be taken into account to understand reform trajectories in Western Europe.

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Paper 1
The political economy of the Agenda 2010 reforms: How Gerhard Schröder overcame the 'Blocked Republic'

Abstract

This paper addresses the puzzle as to why the so-called 'Agenda 2010' reforms – arguably the only noteworthy overhaul of the German welfare system since the Second World War – was undertaken only in the early 2000s by the social democratic government of Gerhard Schröder and not by any of the conservative governments that preceded it. It employs an augmented veto player framework, which allows for the separate analysis of three distinct 'veto clusters' within Germany's political economy. Drawing on primary research as well as secondary sources, the paper compares four distinct episodes of the German political economy, namely the pre-reunification period of the 1980s, the post-reunification period of the 1990s, the first social democratic government under Chancellor Schröder from 1998 to 2002, and the second government of Chancellor Schröder from 2002 to 2005. It finds corporatist institutions, the federal legislative system and the lack of cohesion within the federal government alternately blocked reform in Germany between 1983 and 2002. Only in 2003, when the blocking power of all these constraints waned, was it possible for the federal government to implement far-reaching socio-economic reforms.[1]

[1] Revised version of a paper published 2008 in *ACES Cases*, No. 2008.3, American Consortium on European Union Studies, EU Center of Excellence Washington, D.C.

2.1 Introduction

In his first government declaration after coming into office in October 1982, Chancellor Helmut Kohl announced a 'policy of change' with the objective of 'reducing the state to its core competences'.[2] This raised expectations that the conservative liberal coalition of the *Christlich Demokratische Union* (CDU), its Bavarian sister party the *Christich Soziale Union* (CSU) and the *Freie Demokratische Partei* (FDP) would embark on a radical reform path similar to the policies initiated in several Anglo-Saxon countries at the time. However, no radical reform of the German socio-economic institutions – the welfare system and regulated labour market, for example – followed. Instead, the country's resilience to structural reforms became proverbial. With policy changes apparently impossible even in times of low economic growth and high unemployment, Germany became known as the 'the blocked republic'.[3]

Notable political science scholars have argued that Germany's complex politico-economic structures obstruct economic reform policy (Kitschelt & Streeck 2004, Welsh 2005), rendering Germany a *de facto* 'semi-sovereign state' (Katzenstein 1987). That is, a very large number of socio-economic actors exert their authority in the process of policy formulation and legislation, effectively preventing a majority-backed government to put into practice any paradigmatic policy change, particularly reform pertaining to the institutional structure of the political economy. Katzenstein (1987, 351) finds that, 'within the constraints and opportunities that characterise the Federal Republic, incremental policy change [...] is a politically logical choice'.

The 'Agenda 2010' reforms, however, stands in contrast to this conventional wisdom about Germany. Announced by Chancellor Gerhard Schröder in 2003, this policy initiative intended to reform the institutional structure of the German labour market, the social security system, the tax system, and the research and education system to address 'the challenges [...] of the 21st century.' (SPD 2003, 6, original in German). The legislative changes subsequently implemented are commonly held to be 'the most ambitious seen in post-war Germany', resulting in a significant overhaul of the German socio-economic system.[4] And Schröder's successor, Chancellor Angela Merkel, lauded the reform policies as 'historical'.[5]

[2] Government Declaration of the Federal Chancellor to the German Bundestag, 4 May 1983, Bonn, translation.

[3] Die blockierte Republik, Der Spiegel, 21 September 2002.

[4] The Economist, 18 December 2003.

[5] Frankfurter Allgemeine Zeitung, 22 August 2006. Other regular critics of the social

This assessment is broadly confirmed by academic analyses (Egle & Henkes 2003, Trampusch 2005, Schmid 2006).[6] Structural reforms can be defined as enacted government policies intended to fundamentally change for the better the institutional structure governing a policy sector.[7] While there were of course some instances of change to welfare and labour market regulation that broadly fall into this definition of structural reforms also in the 1980s and 1990s, these remained isolated and limited in scope. The Agenda 2010 reforms constitute the only successful, wider overhaul of the German socio-economic system since the Second World War. Brenke & Zimmermann (2008, 117) identify a 'renunciation of a welfare-biased economic and labour market policy [...] in Germany'. In Esping-Andersen's taxonomy of welfare systems (Esping-Andersen 1990), the policies have clearly moved Germany's 'conservative' welfare state model towards greater individual responsibility – the 'liberal model' – and more tax-financed social security – the 'social democratic model' (Hassel & Williamson 2004, Egle 2006).

Given that this type of structural reforms has been on the policy agenda of the Federal Republic since the early 1980s, the Agenda 2010 reforms present an empirical puzzle. Why was it possible for Germany to deviate from 'the logic of incremental change' and introduce more radical structural reforms? Why was the first major reform of the German socio-economic model undertaken by the second Schröder government coalition, comprising the social democratic *Sozialdemokratische Partei Deutschlands* (SPD) and *Bündnis 90/Die Grünen* (Greens), and not by any of the conservative governments under Helmut Kohl or the first social democratic government under Gerhard Schröder that preceded it?

This paper will show that the Schröder-led government managed to break the political gridlock and introduce structural reforms because the binding constraints of Germany's political economy had lost their powers. To understand how a 'window of opportunity' (Kingdon 1984) for structural reform in Germany opened, it will, in the following Section 2, present an analytical framework, in which to analyse institutional stability and change in Germany. More specifically, it will critically discuss the popular use of the 'Veto Player Model' for the analysis of the German political economy and suggest an alter-

democratic government conceded that the reforms were 'more than just a first step in the right direction'(German Council of Economic Advisors 2003, 2, original in German).

[6] Some have disputed the political and economic significance of the reform agenda, calling it a 'moderate reform' or an 'emergency fix' (Zohlnhöfer 2004, Merkel & Petring 2007).

[7] Please refer to the introduction of the PhD project for a detailed discussion of the concept of 'structural reforms'.

native, augmented veto player framework. In Section 3 this framework is used to analyse the causes for reform inertia between 1982 and 2002, despite varying political constellations and changes in the country's economic structure, while Section 4 will show how the framework helps to understand the passing of the Agenda 2010 reforms. The two empirical sections of the paper make use of a broad spectrum of sources, including semi-structured and narrative interviews (conducted between 2006 and 2008 with German policy-makers, government officials and journalists), newspaper articles, official documents, macroeconomic data as well as a large secondary literature. Finally, the concluding section summarises and discusses the findings of the empirical sections of the paper and carries them forward to understand the economic policies of the grand coalition government of the CDU/CSU and the SPD government under Chancellor Angela Merkel that came into office in 2005.

2.2 The analytical framework

Germany's post-war political system was designed to avoid instability and abuse of power by dispersing political power among many political and economic actors (Saalfeld 2005). Indeed, the list of policy-constraining actors is long. Within the government, the coalition parties, as well as the relatively independent government bureaucracy (*Ressortprinzip*) have been identified as influential. Outside the government, the German federal system limits the policy-making capacity of the federal government *vis-à-vis* the *Länder*, the federal states. When the opposition parties win elections in a majority of the *Länder*, the government loses control of the *Bundesrat*, the veto-yielding second, federal chamber of parliament. Finally, other outside actors, such as the federal supreme court (*Bundesverfassungsgericht*), the European Union (EU) as well as a multitude of well-organised 'special interest groups' – many of which have privileged access to the policy-making process – also exert constraining political influence. This has raised the question, 'how political decisions in such an interlocking governmental system are at all possible' (Holtmann & Voelzkow 2000, 15, original in German).

Arguably, the dominant analytical framework to analyse German policy continuity and change over the past decade has been the veto player framework, following the 'Veto Player Model' presented in Tsebelis (1995, 2002). In spite of criticism from both historical and rational choice institutionalists (Wagschal 1999, Schmidt 2003b), the intuitive simplicity of the framework has preserved its popularity among researchers studying Germany (Bawn 1999, König & Bäuninger 2000, Siegel 2002, Merkel 2003, Strohmeier 2003, Zohlnhöfer 2003a, Busemeyer 2005, Strohmeier 2006, Saalfeld 2006, Blank 2012, and others).

The following section provides a critical appraisal Tsebelis' Veto Player Model and its application to Germany, arguing that the model is quickly overburdened if it attempts to factor in the important structural components of the German political economy, vital to understanding the country's policy-making process. Rather, it is suggested to break down the complex system of veto players into a number of sub-systems, which allows taking account for these components. It subsequently identifies three pivotal veto clusters in Germany, namely the veto points within the federal government, in the federal legislative system and in the system of corporatist interest representation.

The Veto Player Model and veto clusters

At first glance, the Veto Player Model seems to offer an appealing framework to analyse the highly complex German political system. The model translates the classic analysis of institutional structures in political science into a relatively simple agent-based model, focussing on 'individual or collective actor[s] whose agreement (by majority rule for collective actors) is required for a change in policy' (Tsebelis 1995, 301). It thus breaks down complex political structures to one simple question: which agents are able and willing to prevent a departure from a policy status quo? More specifically, the veto player framework assesses whether a policy proposal put forward by the agenda setter – typically the incumbent head of government – will meet with the approval or rejection of the so-called 'veto players'.[8] With their veto power, veto players can prevent a departure from a policy status quo if this policy change does meet their policy preferences. Thus the viable policy alternatives are delimited by a 'winset', defined by the individual policy preferences or policy positions of the veto players. The smaller the winset for policy change, the lower the probability that the status quo will change.[9]

[8] Broadly, veto players are either 'institutional veto players', whose political powers are enshrined in the constitution, or 'partisan veto players', whose political power emerges from the constitutional reality.

[9] A corollary of this Model is the Veto Player Theorem, stating that three factors determine the constraints on a government's policy choices: First, given that a larger number of veto players is likely to reduce the size of the viable policy space (the winset). Second, Tsebelis shows that a larger dispersion of policy positions similarly reduces the size of the viable policy space. And third, most veto players themselves are 'collective veto players' – rather than individual veto players, such as the head of state in presidential government systems – and consist of veto-yielding, disparate interests. A more cohesive policy position

At closer inspection, however, the model has some significant drawbacks, particularly when employed as an analytical framework for Germany. First, the model is less apt at explaining policy reform (and structural reform) than it is at explaining policy continuity or incremental policy change. The Veto Player Theorem predicts that 'countries with many veto players will engage in only incremental policy changes.' (Tsebelis 2000, 464) Given the large number of veto players in Germany, it is appropriate to assume a relatively small winset *ex ante*.

Thus, relatively large changes in the political system – for example, large shifts in policy preferences or the falling away of important veto players – are necessary to explain significant reform. To explain radical policy change (and structural reforms) in Germany with the Veto Player Model, Saalfeld (2006, 254) needs to argue, for example, that 'the policy preferences of all veto players had moved towards more market-oriented economic policies in the 1990s [...] facilitat[ing] changes to the status quo in economic, labour market and welfare policies despite unfavourable institutional conditions of "divided government"'. This leaves unexplained, however, what changes in the structure of the political economy precipitated the preference shifts. The Veto Player Model is 'not about how institutions shape policy preferences, but about how institutions influence policy output given actors' policy preferences.' (Ganghof 2003, 3) Understanding how institutions shape policy preferences is, however, indispensable to understand structural reform trajectories of countries over time.

Second, as a macro-political model, the Veto Player Model downplays micro-political factors; the formal and informal influence of individual and group interests within collective veto players. The analysis of collective veto players (such as parliaments, coalition governments, committees etc.) retains a distinct macro-flavour by focusing on formal decision making procedures within these organisations, for example simple versus qualified majority voting. In the Veto Player Model, these formal procedures determine how interests are aggregated and, subsequently, 'collective veto players [are thought to] approximate the behavior of individual ones.' (Tsebelis 2002, 63)

This approach, however, is too limited to sufficiently understand the decision-making process in Germany at federal level. The country's political economy system is characterised by a particularly tight interlock of societal and political actors, both vertically across different levels of government as well as horizon-

of these veto players increases their veto power against a change in the status quo.

tally across different entities at federal level. The vertical interlock stems, for example, from overlaps of powerful partisan interests across state, federal and EU decision-making bodies. At the same time, partisan and other societal interests – such labour, employer, environmental, religious etc. interests – are represented horizontally across the decision-making bodies at federal level. This makes the identification of veto points in Germany – as Merkel (2003) points out – very difficult.[10]

Note that, in addition, this interlock implies that policy position of collective veto players can exhibit significant dynamism. Changes in the policy position may, for example, result from elections not only at national but also at sub-national level, changing the composition in the *Bundesrat* for example. They may also result from changes in relative power or policy position of other societal interest groups within in the important collective veto players. These dynamics add a further degree of complexity also to instances of 'coalitional engineering' (Häusermann 2010) and package deals, which often cut across collective veto players and make the analysis on the basis of conventional institutional and partisan veto players all but impossible.

Third, the Veto Player Model fails to capture different forms of interaction between (groups of) agents. The model draws heavily on general equilibrium analysis in economics, which shows how bargaining and exchange between agents leads to Pareto improvements of resource allocation. The decision-making process in the veto player framework is understood as a similar bargaining process among the veto-yielding agents. The policy options – equivalent to exchange options in the market setting – are delimited by the winset, in which Pareto improvements for veto players are possible. By its very nature, the form of political interaction of the veto players is consensual; actors are willing to constructively interact with other actors. A key underlying assumption of this approach is that actors genuinely care about the implemented policy and about changing the policy status quo towards their policy position.

The motivation to veto a policy reform initiative may, however, be driven

[10] Addressing the puzzle of institutional stability in Germany of the 1980s and 1990s Zohlnhöfer (2003a, 137) emphasises the importance of veto player 'cohesion', for example. He argues that 'Christian democrats lacked consensus on what ought to be done in economic policy and how far-reaching reforms should be. While the business factions of the CDU/CSU as well as the FDP demanded comprehensive market oriented reforms, the Social Committees defended the status quo and were only willing to accept marginal changes.' Note that this finding contradicts the Veto Player Theorem. Also, given that business and welfare factions within Germany's parties interlock with employer organisations and trade unions respectively, it may be more appropriate to include the social partners as distinct veto points in the analysis.

by other considerations than policy substance. Partisan veto players are, for example, commonly driven by vote or office seeking motives. A veto may thus be used to hurt the reputation of the government rather than to exert influence on policy substance. These veto players have been referred to as 'competitive veto players' in distinction to the conventional 'cooperative veto players' in the Veto Player Model (Wagschal 1999, Crepaz 2001, Wagschal 2005).[11] Also, the policy position of some institutional veto players – such as constitutional courts or central banks – will not typically reflect the aggregate policy preference of the collective actor, but be driven by the legal or statutory mandate of the actor.

In summary, the Veto Player Model was developed as a contribution particularly to comparative political science, aiming to 'unify the comparative analysis of political systems' (Ganghof 2011, 2707). While it deserves much merit for allowing the joint assessment of seemingly incomparable political systems, it does less well in understanding policy dynamism over time, particularly in countries with a highly complex, interlocking politico-economic system. Accounting for the dynamics in policy preferences, all micro-political factors and the different forms of political interaction takes the compelling simplicity of the analytical framework *ad absurdum*. Thus, the original Veto Player Model loses much of its appeal for an analysis of Germany's structural reform trajectory over the past decades.

To address the problems of the original veto player framework for the analysis of countries such as Germany, this paper suggests breaking down the decision-making system into a number of sub-systems. The original Veto Player Model captures the entire political system in one single political bargaining game. Alternatively, this paper suggests analysing the policy proposal of an agenda setter in a number of sub-games, each of which captures an important aspect of political interaction in the economic policy-making process (see Figure 2.1 on page 64). More specifically, this adapted analytical veto player framework suggests the separate analysis of 'veto clusters' rather than all veto points at once. Following the original Veto Player Model, policy change in the augmented veto player model can come about if the policy proposal is not blocked by one or more veto clusters.

[11] Note that the logic of the Veto Player Theorem does not necessarily apply to the interaction of competitive veto players. For example, Tsebelis (2002) contends that the number of veto players is reduced if the policy position of two veto players overlap. This 'absorption rule', however, does not hold for competitive veto players, which may yield their veto for non-policy related reasons.

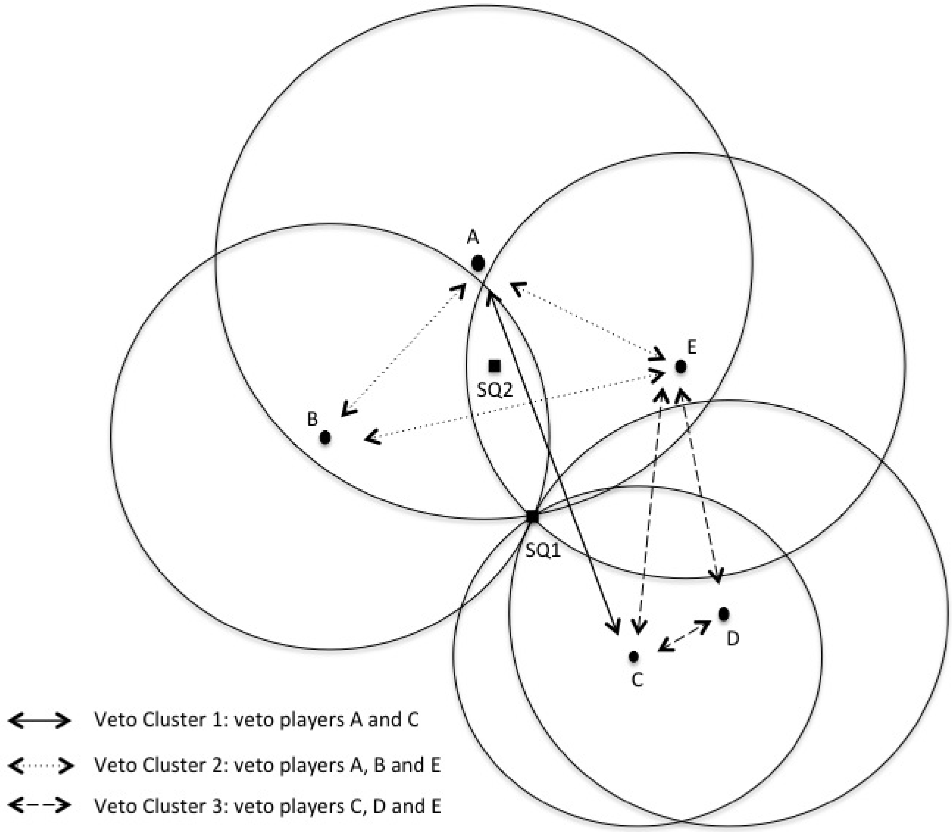

Figure 2.1: The political system consists of five veto players A, B, C, D and E. There are three veto clusters consisting of players A and C (Cluster 1), players A, B and E (Cluster 2) and players C, D and E (Cluster 3), which interact among each other. Note that veto players can be part of more than one cluster, allowing to account for political interlock. In this example, agreement on a change of the policy status quo from SQ1 to SQ2 would only emerge in Cluster 2, given that SQ2 is inside its winset. Cluster 1 and 3 would not agree on SQ2 and there would be no policy change. Note that the result is equivalent to a simply Veto Player Model. However, the cluster approach allows a more differentiated analysis of the relevant political interactions.

As the following study will show, the advantage of analysing the German polity in decision-making sub-systems allows a more differentiated understanding of the economic policy-making process. First, it is easy to see that this approach allows for different – cooperative, competitive and possibly other – forms of interaction among actors. For example, interaction among coalition partners in a government – a first cluster – may be ruled by genuine concerns about policy content, while interaction between the governing and the opposition parties – a second cluster – may be ruled more by office-seeking motives.[12]

Second, a clustering of veto players also allows a better grasp of the interlocking nature of the German political economy, particularly if important collective veto players are modelled as veto clusters. More specifically, veto clusters overlap where a particular veto point features in more than one veto cluster. For example, a political party could feature as a veto point both as a coalition partner in the federal government as well as in one or more governments at *Länder*-level. Similarly, trade union interests could feature as a veto point both within a government (if it has strong influence on the policy position of the welfare policy of a social democratic government, for example) and as a veto point in tripartite negotiations.

Third, veto clustering allows taking into account the dynamics of Germany's political economy more easily. By focussing on veto clusters with a manageable number of veto points, the impact of shifts of socio-economic structures on policy preferences – which are too easily dismissed in the agent-based Veto Player Model – can be assessed at a reasonable expense. Put differently, the veto clusters allow the reintroduction of structural factors into the framework overly determined by agency.

The disadvantage of the veto cluster approach is clearly that it disallows comparative studies. Veto clusters are likely to be highly idiosyncratic. While enhancing the analytical leverage of a country case study, breaking down the system implies that the model will no longer travel to other countries. Additionally, the approach requires the correct identification of the relevant clusters in the political system. Note that relevant veto clusters may differ across policy issues. This requires a detailed description of the respective political system, which is provided in the following for Germany.

[12] Note that in the latter case the analysis of policy preferences and winsets of the original Veto Player Model is thus superceded by other factors and largely obsolete.

Veto clusters in the German political system

Three veto clusters determine economic policy in Germany: (1) the relevant veto points within the federal government, particularly the coalition parties in the German *Bundestag*, (2) the relevant veto points in the federal legislative system, particularly also the political parties represented in the *Bundesrat* by means of their governing majority in the *Länder*, and (3) the relevant veto points within the German system of corporatist interest representation, particularly the trade unions and employer organisations.

The first veto cluster in the German political system comprises the actors within the federal government (Cluster I). Both the electoral as well as the party system in Germany result in a relatively large diversity of parties in the *Bundestag*, which requires careful coalitional engineering to form stable governments. Two parties – the CDU/CSU and the SPD – conventionally dominate the political agenda in Germany. However, as neither the CDU/CSU nor the SPD have ever been able to gain an absolute majority in an election at the federal level, German federal governments have always been coalition governments. The FDP, the only other party represented in parliament until the early 1980s, was joined by the Greens in 1983 and the *Partei des Demokratischen Sozialismus* (PDS, renamed *Die Linke.PDS* in 2005 and *Die Linke* in 2007) in 1990. Until 2005, economic policy changes have required the consent of either the FDP, which has been sternly pro-market since 1982, or the Green Party, which has settled for a moderately social democratic economic policy platform.

Another complicating factor in Germany's government system is the role played by the two large parties as 'catch-all parties', which adds additional veto points to coalition governments. Their members have traditionally encompassed a broad range of different political viewpoints and ideologies on economic policy. The CDU/CSU is generally said to be more sympathetic to business, while the SPD tends to be more sympathetic to the interests of workers. However, close links to organised labour, employer interests and other associations are important in both parties. In the CDU/CSU, the 'Social Committees' (*Sozialausschüsse* or *Christlich-Demokratische Arbeiterschaft*, CDA) represent the labour wing, while the *Mittelstands- und Wirtschaftsvereinigung* (merged to form MIT in 1995) represents business interests inside the party. Within the SPD, the *Arbeitsgemeinschaft für Arbeitnehmerfragen* (AfA) has traditionally been close to the trade unions, while the *Seeheimer Kreis* represents the modernisers in the party.

The second veto cluster captures the federal constitution of Germany, taking account of the fact that much of the federal-state interaction is hosted in the *Bundesrat* (Cluster II), which has evolved into the functional equivalent to an upper house of parliament. Germany's *Grundgesetz* prescribes a strict vertical separation of power between the federal and state level. Over the decades, however, the federal level has gained direct legislative authority in more and more policy fields, mostly by recourse to the constitutional provision of having to 'ensure equal living standards' across the country (Art. 72, Para. 2 Basic Law). This provision has severe implications for policy-making at the federal level. Typically, the *Bundestag* should be able to overturn a veto by the *Bundesrat* (*einfache Gesetzgebung*). In practice, however, 55-60 percent (Schindler 1999, 967) of legislation needs the approval of the *Bundesrat* (*zustimmungsbedürftige Gesetzgebung*) because it touches the competences or finances of the *Länder*. The *Länder* have thus gained considerable influence at the federal level via the *Bundesrat*.

This point is crucial because the governing coalition usually does not have the support of the *Bundesrat*, i.e. the state governments represented in the federal chamber are backed by parties that are part of the opposition in the *Bundestag* (two out of three years since 1949). Burkhart & Manow (2004) show that, while the number of legislative proposals actually vetoed by the Bundesrat is not significantly higher in divided government than in cases when the same parties have a majority in both the Bundesrat and the Bundestag, the 'anticipated veto' by the Bundesrat will effectively stop the government from initiating far-reaching policy reform and structural reforms.

Note that this veto cluster diverges from the 'Joint Decision Trap', put forward by Scharpf (1988). The joint decision trap describes how a federally-organised entity such as Germany (or the EU) is biased towards lowest common denominator policy decisions due to the veto power of *Länder* governments. Scharpf assumes autonomous policy decisions by *Länder* governments. For the purpose of this paper, it is argued that party discipline compels *Länder* governments to adhere to the federal party policy line. This assumption is reasonable for policies pertaining to federal legislation on wage bargaining, unemployment protection, unemployment benefits, health insurance etc.

The third veto cluster captures the system of corporatist interest representation in the German political system (Cluster III). This system includes arrangements by which interest groups are included in the political decision-making process. These interests groups comprise first and foremost the trade unions represented by the *Deutscher Gewerkschaftsbund* (DGB) – including *IG*

Metall, ÖTV and DAG (now *Ver.di*), *IG Bergbau, Chemie und Energie* among others –, employer organisations – including the *Bundesverband der deutschen Industrie* (BDI), the *Bundesvereinigung der deutschen Arbeitgebervertretungen* (BDA), the *Zentralverband des deutschen Handwerks* (ZDH) and the *Deutsche Industrie- und Handelskammertag* (DIHK) amon others – as well as welfare associations. These social groups are represented in the governing bodies of important para-statal institutions, such as the federal labour office, the social security institutions, universities and the public broadcasters.

Beyond the tripartite-governed para-statal institutions, however, they also exert informal political influence, particularly by means of close linkage to political parties. For example, there are traditionally leadership overlaps between the political parties, trade unions and employer organisations (Hassel 2006). The closely interlocking network ensures strong political influence of interest groups – particularly of trade unions and employer organisations – on economic policy. In fact, social partnership between government, trade unions and employer organisations that allows resolution of conflict through institutionalised cooperation has long thought to be a hallmark of German corporatism (Streeck 2005b). In consequence, the social order and economic governance in Germany depends, 'not on the strength of the state, but on a balance of power between social groups as well as on a corporatist pattern of social organization' (Streeck & Hassel 2004, 103).

These three veto clusters – the federal government, the federal legislative system and corporatist interest representation – bear notable resemblance to the conceptualisation of the German polity in the wider political science literature. Most prominently, Katzenstein identifies three similar, albeit not entirely congruent interfaces, or 'institutional nodes'.

> First, the transformation of West German parties to catch-all parties with mass appeal and the system of coalition governments act as brake for any major initiatives. Second, West Germany's 'cooperative federalism' has the effect of creating political links among the territorial interests in the Federal Republic which are sufficiently tight to stall all serious attempts at large-scale policy change. Finally, parapublic institutions provide effective mechanisms for representing 'functional interests'. (Katzenstein 1987, 81-82).

Similarly, the concept of the 'negotiated democracy' (*Verhandlungsdemokratie*), another description of Germany's complex policy-making structure that builds on Lehmbruch (1976) and Lijphart (1984), also exhibit some congruence with the veto clusters identified above. Czada (2000, 45) describes the three components of a Germany's negotiated democracy as 'party-political concordance', 'constitutional veto structures' and 'neocorporatist intermediation', which capture very similar elements of Germany's political system as the three veto clusters described above.

It should be noted that this political science literature has highlighted the importance of other institutions in the German political system, such as the *Bundesverfassungsgericht* and the *Bundesbank*. These are not included in the analysis of this paper. The potential veto power of the *Bundesverfassungsgericht* on structural reform policies is significant, for example. However, the court has had very little impact on structural reform policies (Merkel & Petring 2007) and, as Helms (2003) points out, has also lost some of its powers to the EU. The general loss of authority of German institutions to the EU would suggest that the EU needs to be added to the list of veto-yielding institutions. But although the EU itself gained wide competences in the past two decades and also deals with structural policy inside the member states, its real impact on reform policies in member states has proven to be limited.[13]

2.3 Economic policy continuity

To analyse the period of broad institutional stability between 1982 and 2002, the era is divided into three periods. The analysis sets off with a first period that begins with the announcement of the 'policy of change' by Helmut Kohl in 1982 and runs through the 1980s. A second period covers the time from reunification in 1990 until the change of federal government in 1998. A third period, which has come to be known as 'Schröder I', spans the first term of the Schröder government; before the Agenda 2010 reforms were introduced in the second term of the Schröder government ('Schröder II'). The analysis shows how the three veto clusters identified above blocked the implementation

[13] Although the Treaties give the European Union no direct competence in the member states' social and economic policy, the 2000 Lisbon Agenda for Jobs and Growth made structural reforms a key policy area of the Union. The Lisbon Agenda, aimed to make Europe, 'the most dynamic and competitive knowledge-based economy in the world by 2010', intended to use soft policy tools, such as peer review and benchmarking to nudge member states towards more reform efforts. Although speeches and documents on the Agenda 2010 make frequent reference to the Lisbon Agenda and its targets, interviews indicate that the peer pressure effect of EU's Open Method of Coordination in the development of the Agenda 2010 policies was marginal. Rather, reference was made to the Lisbon targets after the policies had been agreed on (see also Hatzopoulos (2007)).

of structural reforms through the 1980s and 1990s.

Economic policy in *Modell Deutschland*

The central obstacle to reform in Germany in the 1980s was not the first or the second veto cluster – the federal government or the federal legislative system – but Germany's corporatist structure (Cluster III). The German economic model – the so-called *Modell Deutschland* – worked well for the dominant interest groups: trade unions and employer organisations representing Germany's manufacturing sectors. Fundamental change of the institutional structure of the German economic model did not find their approval. Beyond some limited budget consolidation and 'public adjuration of market forces' (Schmid 1991, 25, original in German), the Kohl government implemented none of its announced structural reforms.[14]

While Germany had enjoyed two decades of high growth and close to full employment following World War II, the oil crises of 1973 and 1979/1980 significantly dampened Germany's economic outlook. The crises led to a significant rise in unemployment. The social liberal government under Helmut Schmidt responded with a large expansion of welfare spending – around 10 percent per annum – during the 1970s.[15] When the CDU and the FDP assumed government control under Helmut Kohl in 1982, they shifted the policy debate away from demand-side and towards more supply-side economic policy. The relatively high unemployment and slow growth were described as a domestically rooted problem that needed to be addressed by structural reforms. In his 1983 government declaration, Kohl summarized his economic policy plans with the formula 'away from more state, towards more market; away from collective burdens, towards more individual effort; away from encrusted structures, towards more flexibility, initiative and competitiveness' (Kohl 1983, original in German).

Despite this Thatcherite rhetoric, however, no radical changes in the German political economy followed. The value-added tax was increased and spending for selected welfare programs was moderately reduced. For example, a 1983 act accompanying the budget moderately linked unemployment benefit duration to the record of social security contributions. However, the bulk of the budget deficit reduction was financed through the rebounding German econ-

[14] For a detailed description of the economic policy of the Kohl governments, please refer to Zohlnhöfer (2001), for example.

[15] Data source: Own calculations based on DESTATIS data

omy of the mid-1980s. A vocally advertised income tax reform only marginally reduced the average tax burden in the second half of the 1980s. The 'reform' of the legal shopping hours symbolises the overall hesitant reform policy of the time: shops were allowed to remain open two more hours a week (Webber 1992, Katzenstein 1989).

> [In summary,] the government has done little or nothing to improve the working of the market [...]. [P]reservation of inherited structures rather than fundamental reform has been and still is the dominant principle of economic policy in Germany. (Hellwig et al. 1987, 140)

In spite of the economic recovery after the 1982 recession, with growth at around two percent for most of the later 1980s, unemployment remained stubbornly high at around eight percent.[16] This continued to be a pressing problem for the government. Consequently, more radical reforms of the labour market and the welfare institutions should have been easy to rationalise.

If only the two political veto clusters – 'federal government' and 'federal legislative system' – are taken into account, the lack of more radical policy change remains surprising. In fact, the conditions for fundamental economic reform seem highly favourable. First, the CDU/CSU enjoyed very good ratings in the polls, marshalling considerable 'electoral slack' throughout the 1980s. The Christian democratic liberal government had already won a majority of seats in the *Bundesrat* in 1972. Also the CDU/CSU's coalition partner, the FDP, had left the coalition with the SPD hoping to achieve its market-oriented economic policy goals with the help of the Christian democrats.[17] That is, coalition politics and majorities in the *Bundesrat* were conducive to a more radical reform policy. This leaves the corporatist structures of the German economic model as the decisive determinant for institutional stability.

Note, first, that in spite of growth and employment crises, the German political economy of the 1980s firmly maintained the characteristics of the *Modell Deutschland*, the post-war German economic model. While there is no consistent definition of this economic model, it commonly captures Germany's specialisation in high-quality manufacturing niches, a close coordination of

[16] Data source: Own calculations, IMF World Economic Outlook 2008

[17] In 1982 the liberal German Minister for Economic Affairs, Otto Graf Lambsdorff, published a 'Concept to Overcome Low Growth and to Fight Unemployment', renouncing the Keynesian economic policy of the SPD and FDP coalition government. This change in economic policy of the FDP triggered the end of the SPD/FDP coalition.

business interests, particularly in the *Mittelstand*, co-determination in corporate management, and a sophisticated system of vocational training, among other elements.[18] The Varieties of Capitalism literature (Hall & Soskice 2001) develops a model of 'coordinated market economies', showing how firms may use institutional elements found in the *Modell Deutschland* to their advantage. Maintaining that Germany had (and still has) a 'comparative institutional advantage' in 'diversified quality production', the model provides a compelling argument for why Germany's socio-economic institutions facilitated its ascent to world-leadership in the export of high-quality manufacturing products such as luxury cars and machine tools.

It is easy to understand that neither trade unions nor employer organisations were interested in changing this institutional regime so long as it ensured good annual accounts for manufacturing firms and secure, well-paid jobs for their employees. Growth, both of corporate profits and household income, in the German manufacturing sector in real terms were negative in the early 1980s. After 1983, however, real corporate profits grew by an average of over 4 percent, while real household income in the manufacturing sector grew by over 3 percent on average. At the same time, growth of profits and income in the non-manufacturing and particularly in the service sectors was significantly lower.[19] In short, the Germany's specialisation in a skill-intensive, high-quality production regime paid off for the trade union and employer organisation members.

Note, second, that trade union and employer interests were effectively transmitted into the political decision-making process particularly through their influence in the party system. On the one hand, labour-friendly social committees inside the CDU/CSU exerted substantial influence on the economic agenda of the CDU/CSU. Here, it is worth pointing to the strong political position in the CDU of the committee chairmen Norbert Blüm (who was simultaneously a member of the CDU's executive board and Minister of Labour from 1982 to 1998) and Heiner Geissler (who was Secretary General of the CDU). On the other hand, the interests of large- and medium-sized firms were effectively represented in the CDU/CSU by the influential *Mittelstands- und Wirtschaftsvereinigung* (Zohlnhöfer 2001, 42). Regarding the CDU/CSU's junior coalition partner, the FDP always had close tied to corporate interests, the party's core constituents being 'entrepreneurs, middle-class intellectuals as

[18] For two discussions of the term *Modell Deutschland* – from a German and an Anglo-Saxon perspective – see Offe (2002) and The Economist, 14 April 2012

[19] Data source: Own calculations from OECD STAN database

well as business and industry executives' (Kortmann 2010, original in German).

The analysis of the corporatist veto cluster – the policy preferences of actors and their interaction – helps understand why policy impulses of the Kohl government did not translate into structural reform and institutional change. The government's plan to liberalise the labour market in the mid-1980s – a stated priority of the government coalition – failed due to the resistance mounted by both the unions and the employer organisations (Wood 1997, Thelen 2000, Wood 2001a). Both the unions and the employer associations, for example, rejected a coalition initiative to break the monopoly of DGB representatives in the work councils. More specifically, these two groups used their government influence to water down the legislative proposal. This manoeuvre, 'can only be understood in the light of the characteristic patterns of organisation and incentives in German industrial production' (Wood 1997, 24).

Instead of dismantling integral elements of Germany's coordinated market economy, the government returned to demand-side policies. This kept excess labour supply off the market by increasing the social budget. First, the government stepped up its active labour market policies and wage subsidies. Expenditures for these measures rose by 10-20 percent annually until the end of the 1980s (from EUR 14.5 billion in 1985 to EUR 25.1 billion in 1990).[20] Second, the government began encouraging early retirement. These schemes helped firms adjust their labour demand despite highly regulated labour markets. Because companies massively applied these early retirement schemes to lay off workers (Trampusch 2005), the cost of these schemes rose from EUR 95 million in 1985 to EUR 546 million in 1989. By the late 1980s, labour market participation of men between the ages of 60-64 reached only 30 percent, while it stood at 55 percent in the United Kingdom and 65 percent in Sweden (Wood 2001b, 387). The government's tacit support to the German manufacturing sector has been referred to as 'welfare corporatism' (Streeck 2005a, 141).

Economic policy after reunification

Following German reunification, the anchor for institutional stability shifted from corporatism to the federal legislative process, from Cluster III to Cluster II. After a short a post-reunification consensus between the major political parties, business and labour – helped by the domestic demand boom from 1990 to 1992 – the government embarked on new structural reform initiatives. At the same time, the financial burden of reunification on the German wel-

[20] Data: Own calculations, IMF World Economic Outlook 2008

fare system was putting into question core pillars of the *Modell Deutschland*. This weakened the reform-decelerating powers of the corporatist veto cluster. However, the loss of a majority in the *Bundesrat* hindered the Christian democratic/liberal government from enacting more far-reaching structural reforms.

The fall of the Iron Curtain in 1989 and the subsequent, surprisingly fast reunification of Germany in 1990 were bound to preoccupy German political economy. While the political reunification turned out to be less onerous than anticipated, the economic unification of the strong West German economy with the derelict economy of Eastern Germany proved to be very difficult. Kohl's stated primary post-reunification goal was to create equal living standards in the eastern and western regions of the country (Art. 34, Treaty on the Establishment of German Unity). This entailed huge investments to overhaul the decayed eastern infrastructure. Since 1990 about 4 percent of GDP have been paid in transfers from the west to the east regions each year, amounting to roughly EUR 1.4 trillion in 2005.[21] Because East Germany *de facto* acceded to the West German constitution, socio-economic regulations and welfare institutions were automatically applied to former East Germany. With huge increases in unemployment following closure of large sections of the planned economy's industries in the East, active labour market policy and early retirement – which had worked well to stabilise unemployment rates in the 1980s in the former West Germany – became the preferred policy measure to maintain social peace (Wood 2001b, 388). The cost peaked at EUR 52.2 billion in 1992 for active labour market measures and at EUR 18.6 billion in 1993 for early retirement measures.[22] Between 1990 and 1995, 57 percent of the former East German work force took part in active labour market programs (Zohlnhöfer 2003a, 141).

The loose fiscal policy and the one-to-one exchange of the East Mark to the German Mark led to a post-reunification boom, with growth rates of 5.7 percent and 5 percent in 1990 and 1991, respectively. The ensuing high inflationary pressure prompted the *Bundesbank* to drastically increase interest rates, pushing the German economy into recession in 1993. The subsequent rise in unemployment increased the budgetary problem of the government still further, leading to substantial reform pressure by the mid-1990s. The pressure to lower the deficit was further amplified by the need to fulfil the Maastricht criteria of the European Monetary Union (EMU), a second political priority of

[21] Der Spiegel, 22 August 2005, see also Ritter & Deveson (2011)
[22] Data source: Own calculations, IMF World Economic Outlook 2008

the Kohl government. Attempts to consolidate the budget by introducing special taxes, such as the 'solidarity surcharge' (*Solidaritätszuschlag*), cut-backs in welfare spending and a reduction of subsidies, produced only short-term effects; the deficit reached a new all-time high in 1996.

In 1995/1996 the number of unemployed reached the 4-million threshold for the first time. In an attempt to reduce unemployment, the government enter into a tripartite agreement, the 'Alliance for Jobs' (*Bündnis für Arbeit*), with trade unions and employer organisations in 1996. This move was patterned on the 'concerted action' (*Konzertierte Aktion*) approach of the 1960s and 1970s. In a joint declaration, the government, employer organisations and unions agreed on the target to cut unemployment by 50 percent by the end of the decade by. After several informal consultations, however, the 'Alliance for Jobs' ended in April 1996 without an accord, mainly because no agreement on labour market liberalisation could be reached. The 'attempt to use the social capital accumulated in the associations for fundamental reforms' (Streeck 2000, 56, original in German) had failed.

After the 'Alliance for Jobs' came to an end, the Kohl government unilaterally put forward far-reaching economic policy reform proposals, aimed at drastically cutting back expensive demand-side labour market policies. With its majority in the *Bundestag*, the coalition amended the 'Protection against Dismissals Act' as well as other labour market regulation.[23] However, central elements of the labour market reform, pertaining particularly to the benefit system and requiring approval from the *Bundesrat*, did not pass the legislative process.[24] At the same time, a major overhaul of the German income tax system – one of the core policy objectives of the FDP, aimed at reducing non-wage labour costs and increasing work incentives – failed outright in the legislative process after long negotiations.[25] Against this background, it is unsurprising that the Association for the German Language chose *Reformstau* ('reform blockade') as the 'word of the year' in 1997.[26]

How can this economic policy turnaround be explained? Growth and unemployment rates were not significantly worse after the early-1990s recession

[23] More specifically, the government raised the threshold above which employment protection is applicable from five to ten employees, liberalised the use of fixed-term work contracts, cut sick pay to reduce non-wage labour costs (the issue over which the 'Alliance for Jobs' had fallen apart), tightened the criteria under which benefit recipients could refuse a job, and reduced the content of active labour market policy. Associated Press, 7 November 1996.

[24] Frankfurter Allgemeine Zeitung, 30 November 1996

[25] Die Welt, 27 March 1997, Westdeutsche Allgemeine Zeitung, 10 July 1997, Frankfurter Allgemeine Zeitung, 30 July 1997

[26] Die Zeit, 18 December 1997

than they had been following the early-1980s recession. However, in a reaction very dissimilar to that of the mid-1980s, the Kohl government turned away from the 'social partnership' and with its reform policy 'threw down the gauntlet to social peace' in Germany.[27] Social scientists are puzzled that the social committees within the CDU/CSU could not or did not want to prevent reform initiatives from entering the legislative process the way they had in the 1980s (Zohlnhöfer 2004, 313).

To understand the 1990s economic policy of the Kohl government, the effect of reunification on the *Modell Deutschland* as well as the effect of other structural changes that took place in the shadow of reunification have to be taken into account. These developments challenged the consensus among the social partners on the viability of the German economic model. Interview partners both from some of Germany's leading employers as well as from *IG Metall* – arguably Germany's most influential trade union – indicated that cooperation among themselves and with the government was 'different' after reunification, and that their counterparts had become 'less reasonable'. This points towards a less comfortable, more competitive relationship between business, labour and the government.

From the perspective of employers, the convenient system of 'welfare corporatism' and collective wage agreements was increasingly becoming a liability for international competitiveness, particularly for medium-sized employers in the *Mittelstand*.[28] The post-reunification unemployment shock led to a steep rise in non-wage labour costs from around 70 percent of direct compensation in the 1980s to almost 85 percent in the mid-1990s.[29] Large firms were able to relocate labour-intensive production abroad or pass on the costs to their suppliers, but small- and medium-sized firms were forced to bear the cost. Accordingly, with the exception of the post-reunification boom years, profits of German manufacturing firms developed negatively in real terms through most of the 1990s.[30] Small firms increasingly viewed the labour market institutions of the *Modell Deutschland* as a burden rather than an asset for their business operations. With this, key components of the 'coordinated market economy' were being put into question.

At the same time, German firms faced an increasing need to restructure

[27] Süddeutsche Zeitung, 29 April 1996, original in German

[28] 'Non-wage labour costs in Germany reach new record high', European Industrial Relations Observatory, 28 May 1997

[29] Data source: DESTATIS labour market database

[30] Data source: Own calculations from OECD STAN database

their operations and to adapt their business model to a changing international environment. European economic integration and market liberalisation introduced concepts such as outsourcing, market capitalisation, lean production, service economy, and mergers and acquisitions into the German economic landscape, thereby slowly changing established ownership and production structures (Schroeder & Silvia 2003, Kinderman 2003, Beyer & Hoppner 2003). Höpner & Krempel (2003), for example, find that a slow erosion of the cross-shareholder system, the *Deutschland AG*, took place in the second half of the 1990s.

As a result of these developments, a conflict emerged particularly between more and less exposed firms inside the employer organisations regarding the direction of economic policy in Germany. The conflict surfaced, for example, in the attacks of the reform-minded chairman of the BDI, Hans-Olaf Henkel, against the BDA.[31] While the BDI pressed for far-reaching structural reforms, the BDA defended core elements of the German economic model (Streeck & Hassel 2004). Many small- and medium-sized firms started leaving employer organisations (Thelen & van Wijnbergen 2003, Silvia & Schroeder 2007). Discord among different types of employers in the German economy led to a weakening of the political influence of the employer organisations (Lehmbruch 2000).

From the perspective of trade unions, reunification also had severe repercussions. Real income of manufacturing workers had reliably increased through the 1980s and early 1990s, at about twice the rate as in the general economy. In the mid-1990s, however, income growth slowed to below 2 percent, also on account of the increase in social security contributions.[32] At the same time, increasing decentralisation of wage bargaining – particularly in Eastern Germany – combined with high unemployment and changing work environments (Schroeder 2003) also contributed to a significant decrease of unionisation (Hassel 1999). Union membership of the working population fell from around 36 percent in 1991 to about 24 percent in 2000.[33] Lower levels of unionisation not only put substantial financial strain on the trade unions, but – as interview parters confirm – also started undermined their legitimacy in the eyes of policy-makers.

As a result of these developments, interests between traditionalist and more reform-minded trade unions emerged. This conflict is demonstrated, for exam-

[31] Der Spiegel, 23 September 1996, Der Tagesspiegel, 7 July 1998
[32] Data source: Own calculations from OECD STAN database
[33] Data source: Armingeon et al. (2010)

ple, by the policy struggle between the traditionalist head of *IG Metall*, Klaus Zwickel, and his reform-minded deputy, Walter Riester (who later became commissioned with pension reform in the Schröder government).[34] Internal conflict over policy severely weakened the political influence of the labour movement. It also accounts for the declining influence of the trade unions the CDA, the labour wing in the in the CDU (Zohlnhöfer 2003a). By the late 1990s, not one of the board members of German trade unions was simultaneously a party executive.[35] With their internal cohesion, the ability of the labour movement to uphold the status quo was faded.[36]

The resulting weakness in the corporatist veto cluster, which had prevented liberal market reform in the 1980s, did not, however, open a window of opportunity for more decisive structural reform. Note that the 'federal government' veto cluster (Cluster I) remained accommodative to more far-reaching structural reforms: It was the FDP, for example, that pushed its CDU/CSU coalition partner to bring forward the tax reform initiative, which was originally foreseen for after the 1998 elections.[37]

Rather, through the mid-1990s, the 'federal legislative system' veto cluster (Cluster II) created a strong anchor for the institutional status quo. The coalition parties in the federal government – CDU/CSU and FDP – had lost their majority in the *Bundesrat* in 1991. In the early 1990s, the government had been able to cooperate with the opposition by appealing to a 'post-reunification consensus'. Following the economic crisis, however, the opposition adopted a confrontational strategy. From 1995, the new chairman of the SPD, Oskar Lafontaine started to use the *Bundesrat* as a veto tool to undermine the federal government's legislative programme and boost the public profile the SPD. After 16 years in opposition and in view of the electoral success of social democratic parties in other large European countries at the time, office seeking motives strongly dominated policy considerations in the SPD. Major legislative initiatives to reform labour market institutions and the tax system were thus rejected or watered down by the *Bundesrat*.[38] The FDP chairman,

[34] Der Spiegel, 13 October 1997, Focus, 17 November 1997

[35] While during the 1980s 97 percent and 20 percent of SPD and CDU/CSU members of parliament, respectively, were trade union members, these numbers had shrunk to 80 percent and 20 percent by the mid-1990s (Hassel 2006).

[36] An early indicator of the union weakness in the 1990s was the quick, EU-induced privatisation of several state-owned companies in the transport, postal service and telecommunication sector, which the unions were unable to stop. cf. Süddeutsche Zeitung, 29 June 1994

[37] Die Welt, 20 August 1996, Die Zeit, 29 November 1996

[38] Associated Press, 25 September 1997, see also (Lees 2000).

Wolfgang Gerhard, famously complained 'We are in government, but we are not in power!'[39]

Economic policy under Schröder I

The first years of the government of Gerhard Schröder were characterised by severe intra-party conflict. This shifted the determinant for institutional stability from the 'federal legislative system' to the 'federal government' veto cluster, from Cluster II to Cluster I. Following a demand-side economic policy in the months after taking office from the Kohl government, the government's attempts at supply-side institutional reforms were largely foiled by resistance from within the governing coalition.[40]

When SPD and the Greens gained a majority in the 1998 elections, this marked the first time all governing parties were completely replaced by opposition parties in the history of the Federal Republic. Given soaring unemployment and budget deficits, a break with unions and subsequent market-oriented reform attempts, the Christian democratic liberal government had lost the trust of the electorate. A growing perception of a 'justice gap' (*Gerechtigkeitslücke*) emerged (and was actively kindled by the opposition parties), especially in Eastern Germany, where more than 60 percent of the voters moved to the left of the political spectrum, namely the SPD or the PDS.[41] With the slogan 'Social Justice and Innovation', the double act of Gerhard Schröder and Oskar Lafontaine, and a professionally organised election campaign, the SPD managed to draw votes also from reform-oriented conservative voters (Stöss & Niedermayer 2000).

In terms of economic policy, the Schröder government's first months were dominated by a demand-side approach. The 1996 labour market reforms of the Kohl government were revoked, a move that the SPD had promised to carry out in its election campaign.[42] In consequence, public expenditures for welfare measures rose by 6.8 percent. Included in this demand-side economic policy was an income-tax reform that decreased the lower tax bracket and increased the tax allowance. As a concession to the Green Party coalition

[39] Die Zeit, 10 July 1997, original in German.

[40] For a detailed description of the economic policy of the Schröder I government, please refer to Egle et al. (2003), for example.

[41] Frankfurter Allgemeine Zeitung, 14 October 1998

[42] The reintroduction of social security contributions for low income jobs (so-called *630-DM-Jobs*) and rules against pseudo self-employment were especially heavily criticised by employers (Egle 2006, Rose 2003), who warned that the low-wage sector would be pushed back into illegality.

partner, an ecological tax (*Ökosteuer*) on energy consumption was introduced and used to support pension funds. By bringing back to life the 'Alliance for Jobs' (renamed 'Alliance for Jobs, Training and Competitiveness'), the SPD hoped to revive the corporatist institutions that had been challenged during the last years of the Kohl government (Schroeder 2003, 12). In particular, the government tried to have trade unions agree to an employment-friendly policy. However, no compromise could be reached. Apart from the very limited so-called 'Job-AQTIV' labour market law on activation and training measures, concrete results of the "Alliance for Jobs" are difficult to identify (Heinze 2003, Reutter 2004).

The economic policy approach of the Schröder I government changed significantly, following the departure of Lafontaine as finance minister and chairman of the SPD. On finances, Schröder replaced Lafontaine with Hans Eichel, a fiscal conservative. The new finance minister started implemented some limited spending cuts in the welfare and pension system.[43] However, after losing elections in several *Länder* (and subsequently the majority in the *Bundesrat*) and with disastrous results in European Parliament elections, further economic imposition were shelved (Schröder: 'I've understood').[44] At this time, the pressure to reform was reduced considerably as unemployment declined and growth rates picked up in the course of the global internet-economy boom. What followed until 2002 came to be known as the 'policy of the steady hand'[45], although the government did introduce some incremental pension and corporate income tax reforms in 2000/2001.[46] Overall, however, and despite the incoherent policy profile in social, fiscal and employment matters, traditional social democracy dominated the SPD economic policy agenda until the end of Schröder I.

This economic policy is explained by substantial intra-party conflict within the SPD, which can be understood in terms of the 'catch-all party problem' in Cluster I of the analytical framework. In 1998, the SPD rode a wave of 'new social democracy' that was sweeping through Europe at the time, namely the United Kingdom, France, Sweden, Portugal and Italy. But the vague concept

[43] Spending cuts which amounted to about 1.5 percent of the budget in 2000 (Zohlnhöfer 2003b, 198).

[44] Der Spiegel, 13 June 1999, Berliner Zeitung, 6 September 1999

[45] Frankfurter Allgemeine Zeitung, 12 July 2001

[46] The rise of pensions was decoupled from the rise in living standards, and linked to the rise in prices. With the *Riester-Rente*, a second, private pillar in addition to the public pension fund was introduced (Schmidt 2003a, 247-251). The corporate income tax reform lowered the corporate tax rate, but also provided tax breaks on profits from the sale of cross-shareholdings.

Neue Mitte (or 'Third Way', Giddens 1998) and the slogan, 'Social Justice and Innovation', which had worked well in the election campaign, turned out to be 'programmatically empty' (Egle & Henkes 2003, 73). The SPD programme lacked a 'concretion of social democracy's basic values liberty, equality and solidarity' (Meyer 2001, 13, original in German, Egle 2006), resulting in conflict between modernisers and the traditionalists over the economic policy direction of the government.

This conflict emerged most visibly in the rivalry between Finance Minister Lafontaine and Chancellor Schröder. The balancing act between the two, which had carried the SPD into government in 1998, quickly broke down after the election.[47] Lafontaine is a self-proclaimed left-Keynesian. Schröder's approach to economic policy is characterised by pragmatism and reformism. A close advisor describes his role – then as minister president of Lower Saxony – in committees as follows. 'Schröder never – in contrast to his eternal adversary Edmund Stoiber – prepared for meetings particularly thoroughly. He would listed to technical discussions passively. However, he would typically be the one to make the winning, compromise proposal.'[48] At the same time, Schröder surrounded himself with reformist social democrats, such as Bodo Hombach (Federal Minister for Special Tasks), Frank-Walter Steinmeier (Chief of Staff in the German Chancellery), Alfred Tacke (State Secretary at the Federal Ministry of Economics and Technology) and Uwe-Karsten Heye (Government Spokesperson). He maintained close ties with German industry, which he had established during his time as minister president.[49]

Although the modernisers in the SPD gained the upper hand over traditionalists, Schröder's subsequent attempts to introduce supply-side structural reforms failed due to the resistance of his own party, which – as interview partners close to the government explained – was not 'ready' for more innovative policy changes. In June 1999, Schröder and Britain's Prime Minister Tony Blair published a paper titled, 'The Way Forward for Europe's Social Democrats' (Blair & Schröder 1999), which can be understood as an attempt to reaffirm the chancellor's commitment to the 'Third Way' concepts and as a rejection of Keynesian policies. Both the paper and the fiscal consolidation policy evoked strong resistance from the SPD labour committee AfA and the parliamentary fraction. Labour representatives called the Blair-Schröder

[47] Der Spiegel, 4 October 1999
[48] original in German, see also Murswieck (2003), Egle (2006)
[49] Die Zeit, 14 March 2002

paper a 'historically blind defamation of the welfare state.' [50]

At the same time, as coalition partners, the Greens experienced a similar programmatic debate. As a relatively young party, grown out of the environmentalist movement, the Greens had not agreed on a consistent economic programme when they assumed government responsibility, apart from the eco-tax, which formed their 'key project of an ecological-social modernisation' (Egle 2003, 104) of the German economy; environmental – such as the nuclear power phase out – and societal issues dominated their political agenda. However, it is probably true that *Bündnis 90/Die Grünen* pushed the SPD in the direction of more rather than less structural reform.

The analysis of policy preferences in the federal government veto cluster suggests that intra-party conflict (Cluster I) was the decisive anchor for institutional stability in the Schröder I government. The 'federal system' and 'corporatism' veto clusters only had a secondary role. With regards to the role of the federal legislative system, the SPD lost its majority in the *Länder* just a year after coming to power. With the majority in the *Bundesrat*, conservative parties were able to block structural reform initiatives of the government. Indeed, the *Bundesrat* blocked a more significant reduction of subsidies in the context of its 2000 tax reform.[51] Overall, however, there were few supply-side reform projects were introduced into the legislative process.

With regards to the role of corporatism, Heinze (2003) argues that the stronger integration of trade unions into the decision-making process through the 'Alliance for Jobs' increased the immobility of the government. Instead of more innovative reforms, the 'Alliance for Jobs' delivered a deadlock in labour-market policy. By 2000, however, the negotiations had practically come to an end, after which time members did not reconvene. Incremental reforms, such as the corporate tax reform of 2000 – which was expected to further disentangle the 'Deutschland AG', the strong cross-householdership between large German banks, insurance companies and industrial enterprises in Germany – and the pension reform of 2001 were not successfully resisted by the social partners. This suggests that rather than acting as a binding constraint on government policy, the constraining powers of the corporatist veto cluster remained weak.

[50] Frankfurter Allgemeine Zeitung, 10 July 1999, original in German

[51] Handelsblatt, 14 June 2000

2.4 Economic policy under Schröder II: The Agenda 2010

The following section provides a short description and analysis of the Schröder II government and its central economic policy programme; the Agenda 2010.[52] It argues that the government was able to implement these Agenda 2010 reforms because all three veto clusters of the German political economy had lost their constraining power.

In 2001/2002, the economic situation in Germany deteriorated drastically, in step with the global economic downturn following the 9-11 terror attacks. Growth rates plummeted (from 3.2 percent in 2000 to zero in 2002), and unemployment rose quickly (from 7.8 percent in 2001 to 8.7 percent in 2002), putting pressure on the government to end its 'steady hand' policy. A scandal in the Federal Labour Agency in spring 2002 served as an opportunity to reopen the structural reform debate.[53] Schröder not only replaced the head of the agency and modernised the corporate governance structure. More importantly, he set up a 'Commission for Modern Provision of Services in the Labour Market' (*Kommission für Moderne Dienstleistungen am Arbeitsmarkt*), tasked with developing a reform concept to make the German labour market and the job placement system more efficient. It became known as the 'Hartz Commission' after its chairman Peter Hartz, a former board member of the Volkswagen AG.

In August 2002, the Hartz Commission presented 13 reform proposals. These included a more far-reaching reform of the Federal Labour Agency. But the Commission also proposed measures to increase pressure on the unemployed, encourage the integration of the labour and social assistance administration, introduce a low-wage sector (*Mini-Jobs*), promote entrepreneurship (*Ich-AG*) and intensify the use of temporary employment agencies (*Personal-Service-Agenturen*). The national wage bargaining system was not touched by the proposals.[54]

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[52] For a detailed description of the economic policy of the Schröder II government, please refer to Egle et al. (2006), for example.

[53] In the so-called 'placement scandal' (*Vermittlungsskandal*) the Federal Court of Auditors had uncovered that the BA had grossly overstated its job-placement success rates.

[54] *Moderne Dienstleistungen am Arbeitsmarkt: Vorschläge der Kommission zum Abbau der Arbeitslosigkeit und zur Umstrukturierung der Bundesanstalt für Arbeit*, report of the commission under the chairmanship of Dr. Peter Hartz, available online at `http://www.bmas.de/DE/Service/Publikationen/moderne-dienstleistungen-am-arbeitsmarkt.html`, retrieved 23.06.2013 21:02, see also Schmid (2003), Jann & Schmid (2004)

These proposals notwithstanding, the SPD was in danger of loosing the September 2002 federal elections on the grounds of the country's poor economic performance. The CDU/CSU candidate, Bavarian minister president Edmund Stoiber, boasted better credentials on economic issues.[55] In the 2002 election campaign, Schröder promised to implement the reform proposals of the Hartz Commission 'one-to-one'.[56] The SPD's narrow victory was, however, not attributed to its economic reform agenda, but to the government's opposition to the US-led military intervention in Iraq and Schröder's shirt-sleeved handling of the Elbe-floods in the same year.[57]

This 'blood and flood effect' – as one interview partner put it – did not last long, and the SPD lost dramatically in the polls in the first months of its second term in office. Instead of returning to a 'steady hand' policy, however, Schröder moved forward on the reform agenda. On 3 March 2003, he announced the breakdown of the 'Alliance for Jobs' – on which there had been no active negotiations for more than three years – and added that he intended to go ahead with a reform programme, without the participation of the social partners.[58] On 14 March, Schröder addressed the *Bundestag* and released details of a new, broad reform package, the Agenda 2010. The reform agenda addressed labour-market policy, taxes, higher education and job training, as well as the pension and health insurance system. The Chancellor justified his structural reform policies with the need to make Germany's social market economy sustainable: 'The alternative is obvious: Either we modernise our social market economy or we will be modernised by the untamed powers of the markets.' (Schröder 2003, original in German)

The central element of the structural reform package was the change to labour legislation, which adopted most of the Hartz Commission's proposals. These proposals resulted in four new, separate labour market laws, known as Hartz I, II, III and IV. Employment protection was liberalised by the provision that dismissal protection applied only to firms with more than ten, instead of five, employees. The legislation also merged secondary unemployment assistance (*Arbeitslosenhilfe*) with social welfare (*Sozialhilfe*) by creating *Arbeitslosengeld II* from January 2005 (known as 'Hartz IV'). Legislation additionally reduced the period of primary unemployment assistance (*Arbeitslosengeld I*) from 18 to 12 months (with an exemption for persons above the age of 55),

[55] Handelsblatt, 8 April 2002, Financial Times Deutschland, 22 September 2002
[56] Handelsblatt, 18 July 2002
[57] Der Spiegel, 23 September 2002, Die Welt, 14 August 2012
[58] Der Tagesspiegel, 4 March 2003

thereby increasing the pressure on long-term unemployed people. The provision that unemployed people are compelled to take up any legal occupation was first removed due to pressure from inside the SPD, but later reintroduced on account of the opposition in the parliamentary arbitration committee. Finally, craft legislation was simplified by reducing the requirement of 'master craftsmanship' (*Meisterzwang*) from 94 to 41 crafts.[59]

Many SPD supporters were highly dissatisfied with the proposals and harsh critique came from the trade unions and welfare associations.[60] For the traditionalist camp inside the SPD and for the PDS, in particular, the Agenda 2010 heralded the end of the German welfare state and aroused fierce protest.[61] Employer associations reacted positive at first.[62] However, as more details about the reform plans emerged, employer organisations became more critical, lamenting the persistent 'reform deadlock'.[63] While the general feedback from the press and academia was cautiously positive, a substantial number of analysts questioned the economic viability of the supply-side reforms (Offe 2003, Hickel 2003).

In the following 18 months, the SPD saw an unprecedented loss of voter confidence and the party reached historic lows in the opinion polls. Dissatisfaction was strongest in Eastern Germany, where trade unions organised several mass demonstrations.[64] Undoubtedly, the Hartz IV legislation helped the PDS (and the right-wing *Nationaldemokratische Partei Deutschlands*, NPD) win electoral gains in Saxony and Thuringia. In Western Germany, a number of frustrated SPD politicians and union officials established the *Wahlalternative Arbeit und Soziale Gerechtigkeit* (WASG). The new party saw itself as a representation of those disadvantaged by Agenda 2010 and wanted to create a political alternative 'left of the SPD'.[65]

When statistics showed more than five million unemployed in January 2005 because social-assistance benefactors were now included in the unemployment statistic, the government could not convincingly prove the feasibility of its

[59] This brief summary of Agenda 2010 illustrates that parts of the Hartz-reforms were modelled on the 1996-1998 reforms of the Christian democratic liberal government, 'which following the change of Government in 1998 were deemed anti-social and repealed' (Ubber 2004, 136). However, the reforms then go well beyond the 1996-98 measures.

[60] Süddeutsche Zeitung, 23 July 2003, Frankfurter Allgemeine Zeitung, 1 August 2003, Handelsblatt 23 October 2003

[61] Süddeutsche Zeitung, 11 December 2003

[62] Die Welt, 15 June 2004, see also (Weßels 2006)

[63] Der Spiegel, 28 May 2003, Bildzeitung, 6 October 2004

[64] Der Spiegel, 3 April 2004

[65] Frankfurter Allgemeine Zeitung, 19 March 2004

supply-side reforms. The SPD lost state elections in its former stronghold North Rhine-Westphalia in March 2005, at which point Schröder announced that he intended to dissolve the Bundestag and call new federal elections.[66] In October 2005, the red-green government was voted out of office and replaced by a grand coalition of CDU/CSU and SPD parties under the chancellorship of Angela Merkel. Gerhard Schröder stepped down from all political offices.

The Agenda 2010 seems to fundamentally contradict established knowledge that institutional change in Germany is incremental by nature. The red-green coalition made a remarkable shift in its policy from its demand-side policies of 1998-1999 to the far-reaching supply-side reforms of 2003-2005. To see how the political economy such facilitate drastic policy change, we again examine the three veto clusters, 'federal government', 'federal legislative system' and 'corporatist interest representation'.

First, by the time of his second term in office, Schröder succeeded in established a cohesive federal government. After the departure of Oskar Lafontaine, SPD modernisers had gradually gained an upper hand on economic policy matters. Incremental reforms, such as the corporate tax reform of 2000 and the pension reform of 2001, stand in sharp contrast to the attempts of Concerted Action in form of the 'Alliance for Jobs' and indicate that the Schröder government was gaining more political room for manoeuvre.[67] In many ways, the these reforms can be understood as a pioneer of the Agenda 2010.

After the 2002 elections, Schröder further consolidated the hold of the modernisers on government. Interview partners particularly stressed the importance of the merger of the the Federal Ministry for Labour (*Bundesministerium für Arbeit und Soziales*) and the Ministry for Economic Affairs (*Bundesministerium für Wirtschaft und Technologie*) under the leadership of the former minister president of North-Rhine Westphalia, Wolfgang Clement. The merger of the traditionalist ministry for labour with the business-friendly ministry for economic affairs into a 'super ministry' for economic affairs and labour is seen as an important factor supporting labour-market reforms.

Interviewees close to the decision-making process in Berlin also maintain that Gerhard Schröder gradually adopted a 'presidential' style of government.[68] This further contributed to the weakening of the SPD's labour wing, by making the policy-decisions more independent from opposition within his own party. Schröder's exceptional media skills were helpful in this context, earning him

[66] Die Zeit, 22 May 2005, Frankfurter Allgemeine Zeitung, 19 December 2005
[67] The Economist, 20 July 2000, Handelsblatt, 17 December 2000
[68] see also Berliner Republik, June 2004 and Murswieck (2003)

the title of ‘media chancellor’ (*Medienkanzler*).[69] They permitted Schröder to communicate directly with the electorate. For example, well-known for his excellent sense of drama, Schröder proclaimed in the German *Bundestag* – in the manner of another famous German reformer, namely Martin Luther – ‘I stand here because there has to be change, because that is the appropriate reaction to the changed situation of our society.’[70] (Schröder 2003)

Second, the CDU/CSU-led *Länder*, which held a majority in the federal chamber, did not block Agenda 2010. Although the CDU/CSU could have followed a vote-seeking, confrontational veto strategy similar to that of the SPD in the mid-1990s, it broadly decided on a policy-seeking strategy. Interview partners confirm that the conservative parties decided to cooperate politically, while voicing ‘rhetorical critique’ in public. The opposition called for restrictions on the independent wage-bargaining system, a demand that clearly was not going to be met by the government, for example. Nonetheless, opposition parties pushed the government towards more far-reaching reforms in the arbitration committee of *Bundestag* and *Bundesrat*.[71] Accordingly, Zohlnhöfer (2004) credits the CDU/CSU and FDP with exerting important influence on Agenda 2010, for example in the context of the liberalisation of mini-jobs and self-employment. Egle (2006) even refers to an ‘informal grand coalition’ between the red-green government and the CDU/CSU opposition majority in the *Bundesrat*.

Third, social partners were either unable or unwilling to prevent the Agenda 2010 structural reforms. Indeed, the turning point in the economic policy of the Schröder government was marked by the proclaimed end of the ‘Alliance for Jobs’. The ability of the Schröder government to publicly renounce tripartitism stresses the persistent weakness of the corporatist veto cluster. Note that Schröder could simply have maintained the ‘Alliance for Jobs’; an informal institution that simply no longer held meetings. Accordingly, the SPD’s backing away from the the social partners – especially from its close allies, *IG Metall* and *ver.di* – is identifies as a ‘break in the system’ by many interviewees.

A former senior German executive pointed out ‘The commitment from all partners to the industrial location Germany no longer existed.’ This points to the fact that attempts to harness corporatist structures to build a agreement on institutional change failed because a basic consensus on the the aspired economic model had gone missing. Schröder himself describes Agenda 2010

[69] die tageszeitung, 6 September 2002
[70] ‘Here I stand; I can do no other’, Der Spiegel, 8 October 2004, original in German
[71] Der Spiegel, 17 October 2003, Frankfurter Allgemeine Zeitung, 19 December 2003

as a direct consequence of the failed *Bündnis für Arbeit*.[72] On the one hand, employer organisations had increasingly taken a hostile position towards Germany's 'old' economic order and pushed for more far-reaching liberalisation. On the other hand, trade unions remained in a state of disorder. The creeping decentralisation of wage bargaining and the loss of members were forcing the trade unions to restructure and consolidate (Silvia 2008), making them an increasingly unreliable parter for the German industry.[73] This is maybe best illustrated with the example of the 2003 *IG Metall* strike, calling for a 35-hour week for eastern German plants. The stoppages in eastern Germany led to production standstills in western German plants and to protests from work councils; *IG Metall* had to end its strike unconditionally.[74]

Against this background, in the mid-2000s social scientists find that '[t]he organised, corporatist society is in a state of growing disorganisation. Not only does the normal working relationship break apart, the social-inclusive power of the association-state is failing. Big associations are today perceived as a part of the problem by the public.' (Heinze 2003, 142, original in German) Some went as far as to claim that the, 'twilight of the Gods of the post-war corporatism' had come (Weßels 2006, original in German) and that the 'century of corporatism' had ended (Streeck 2005b). Clearly, the relatively unobstructed implementation of Agenda 2010 is a strong indication that – for the time being – corporatism had lost its constraining power on German political decision-making.

However, the weakness of the *Modell Deutschland* in the 1990s and early 2000s does not necessarily imply its complete erosion and the end of corporatist policy-making. Indeed, the Varieties of Capitalism literature questions whether the decline of Germany's coordinated market economy is inevitable (Deeg 2005, Busch 2005, Hancké et al. 2008). Indeed, Germany's economy outlook greatly improved in the second half of the 2000s, arguably also as a result of Agenda 2010 reforms (Zimmermann & Eichhorst 2008).[75] The rebounding German economy was even referred to as a second German *Wirtschaftswun-*

[72] Frankfurter Allgemeine Zeitung, 23 September 2004

[73] Handelsblatt, 17 June 2003

[74] Frankfurter Allgemeine Zeitung, 28 June 2003

[75] The OECD country report in Germany argues that the Hartz reforms, in particular, led to 'greater work incentives and a better matching between labour supply and labour demand.' (OECD 2012, 49, original in German) GDP growth reached 2.9 percent and 2.5 percent in 2006 and 2007 respectively, the German federal budget was balanced for the first time since 1969 in 2007 and, maybe most importantly, unemployment fell from 10.7 percent in 2005 to 9.8 percent and 8.4 percent in the following two years. Data source: EUROSTAT Main Economic Indicators database

der, indicating that the *Modell Deutschland* is more resilient than previously thought.[76] At the same time, more successful German trade union action after 2003 suggests that the process of restructuring and consolidation moved forward and that 'there's life in the old dinosaurs yet'.[77] It is not unreasonable to conjecture that the Agenda 2010 reforms may have been historical exception, required to correct fundamental mismatches in the economy's institutional framework, and that Germany will return to a series of incremental policy changes.

2.5 Summary, conclusion and outlook

The paper set out to answer the question why, after decades of institutional stability, it was possible for a social democratic German government to deviate from the country's 'the logic of incremental change' and, with the Agenda 2010 structural reforms, bring about significant institutional change.

The theoretical section of the paper provides a critical review of the dominant analytical framework for institutional stability and change, namely the Veto Player Model. It argued that the Model quickly becomes overburdened if it attempts to factor in structural and dynamic elements of a complex political economy. The theoretical section presents an augmented veto player framework, which breaking down the politico-economic systems into a number of 'veto clusters'. This allows for a partial analysis of sub-systems that each follow a different political or political economy logic. It identifies three pivotal veto clusters within the German political economy, namely the veto points within the federal government, in the federal legislative system and in the system of corporatist interest representation.

An analysis of economic policy under Kohl and Schröder until 2002 shows that all three veto clusters of the German politico-economic system contributed to the lack of far-reaching structural reforms. Somewhat stylised, it could be argued that strong corporatist structures account for policy continuity in the 1980s, confrontation with federal entities blocked more far-reaching reform projects of the Kohl government in the 1990s, and low intra-party cohesion prevented innovative policy change under the Schröder I government (see Table 2.1 on page 90). The analysis of the German political economy under Schröder II demonstrates that the three veto clusters traditionally cohering

[76] The Economist, 4 January 2007 and 14 April 2012
[77] The Economist, 16 February 2006

the political economy in Germany were fading: the SPD modernisers had assumed control of the economic policy agenda setting; the opposition, which dominated the *Bundesrat*, accommodated supply-side policy changes; and the corporatist structures had been weakened too far to deter innovative policy change. In other words, the formerly 'blocked republic regained its economic policy-making capability to a considerable extent.

	Cluster I	Cluster II	Cluster III
Kohl in the 1980s	cohesive	accommodating	**strong**
Kohl after reunification	cohesive	**confrontational**	weakening
Schröder I	**non-cohesive**	accommodating	weakening
Schröder II	cohesive	accommodating	weakening

Table 2.1: Veto clusters and structural reforms in the German political economy 1982-2005

In terms of its theoretical contribution, the analysis shows how a partial analysis of veto clusters allows for a meaningful analysis of complex political economies over time. First, it allows for cooperative and competitive forms of interaction among actors. For example, interaction among veto players in the federal system were highly confrontational in the late years of the Kohl government, but cooperative among veto players in the federal government. By contrast, in the first years of the Schröder government conflict emerged among the veto players in the federal government, while veto players in the federal system behaved relatively cooperatively. Second, the veto cluster approach allows reflecting the interlocking nature of the German political economy well. The same actors – for example, the parties with a majority in the *Bundestag* – can feature as veto players in more than one veto cluster – for example, in the federal government as well as in the corporatist system. Third, the partial analysis of veto clusters makes the incorporation of dynamics more manageable. This allows, in particular, the analysis of the impact of shifts of socio-economic structures on policy preferences and veto points. Thus the augmented veto player framework also provides a bridge between the agent-based and structural political economy analyses.

In terms of its empirical contribution, the most significant finding of the analysis is the link between the gradual decline of *Modell Deutschland* and the ability to carry out non-incremental policy change.[78] The catalytic effect of

[78] Incremental change in socio-economic institutions can lead to non-incremental, that is to say structural institutional change. In this context, structural institutional change

German reunification and global and European economic integration, among others, led to a change in the preferences of firms, trade unions and the government that, together, sustained the German economic model. Declining support for the German economic model and its cooperative institutions substantially weakened the stability of its corresponding corporatist structures.[79] The following Paper Two of this PhD project provides a more in-depth, theoretical exposition of this phenomenon.

In closing, it is worth noting that the grand coalition government of the CDU/CSU and the SPD under Chancellor Angela Merkel that followed the Schröder government avoided far-reaching structural reforms. This outcome may seem surprising given that both coalition partners entered into the 2005 electoral race with a commitment to institutional change. The leadership of the SPD included Franz Müntefering, Frank-Walter Steinmeier and Peer Steinbrück – all modernisers and close allies of Gerhard Schröder – and was committed to the Agenda 2010 reforms. The CDU/CSU pushed the debate on structural reforms beyond Agenda 2010, for example with the appointment of Paul Kirchhoff, a tax lawyer, former federal constitutional court judge and outspoken reformer, to Angela Merkel's team of advisers. The grand coalition government, however, reversed some components of the Agenda 2010 reforms (Zimmermann 2008), rather than pushing for further change.

In terms of the analytical framework employed for this paper, this course in economic policy is easily explained by means of the federal government veto cluster. Cohesion in the grand coalition was very low. The CDU/CSU's coalition partner, the SPD, underwent significant change after the departure of

is not to be misunderstood as the sum of numerous incremental institutional changes, i.e. 'incremental change with transformative results', as Streeck & Thelen (2005, 9) suggest. The analysis presented here shows how incremental change within a system of apparent institutional stability can reconfigure preferences and political constellations that, in turn, facilitate radical institutional change. Similarly, Dyson (2005) suggests that incrementalism could 'disguise' fundamental structural change by generating 'tipping points' of innovative policy change.

[79] This finding is confirmed by recent research findings on institutional stability and change in Germany. In a book-length study of the 'Hartz IV' reforms – the unemployment assistance component of the Agenda 2010 – Hassel & Schiller (2010) argue that several long-run destabilising factors in the German political economy opened a window of opportunity for reform. More specifically, Hassel & Schiller (2010, 20, original in German) argue that, among other things, 'the cartell of elites in social policy, that was broadly dominated by the social partners until the middle of the 1990s, was dissolved due to the high costs of reunification and became open for new ideas.' In more general terms, (Streeck 2008, 3) finds in his study on institutional change in the German political economy that the '[c]ontinuous, systemic, endemic, dialectical change, gradual disorganization of institutional structures, slowly decaying institutional complementarity, the emergence of tipping points in historical processes where images of stability and stasis no longer serve constructive purposes.

Gerhard Schröder. The emergence of the left-wing party *Die Linke* – a merger of the predominantly eastern German PDS and the WASG – was eroding the traditional party base of the social democrats. A quick succession of party leaders, from modernisers such as Franz Müntefering and Matthias Platzeck, to the more traditionalist Kurt Beck in 2006, left the party in an ongoing dispute over its political direction. Traditionalists regained influence in the party, shifting its policy stance away from modernist towards more traditional social democracy. Reforms such as the Agenda 2010 were almost impossible in view of the low coherence of the grand coalition government.

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Paper 2
Corporatist cartels: Explaining reform trajectories in coordinated market economies

Abstract

This paper addresses the puzzle as to why some European countries live through extended periods of economic underperformance before reforming their institutional structure. First, building on the comparative capitalism literature on 'coordinated market economies', the paper argues that Europe's socio-economic institutions can provide institutional complementarities, beneficial to particular sectors of the economy. Because corporatism allows stakeholders from these sectors privileged access to the political decision-making process, institutional stability and change depends on their institutional preferences; rather than on considerations for aggregate social welfare. Second, the paper presents a formal, game-theoretic model of a coordinated market economy. From this model it derives a set of socio-economic variables that determine institutional stability and change in this type of economy. Third, the paper explores the mechanisms described by the model by examining the reform trajectories of Germany and Sweden.[1]

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3.1 Introduction

Over the past decades, persistently low growth rates and high unemployment put pressure on many continental European countries to reform their socio-economic institutions. There is significant variation, however, in the policy response to this pressure, both in terms of scope and timing. Some countries enacted structural reforms – intended to fundamentally change for the better the institutional structure governing their economy – relatively quickly. Other countries experienced extended episodes of repeated growth and employment crises without noteworthy structural reforms. This is surprising, particularly because this policy divergence can be observed also in European countries that are held to be quite similar in terms of their political, economic and social constitution. Sweden and Germany, for example, both faced a period of low growth and rising unemployment following the 1970s oil crises. On the one hand, however, Sweden already introduced far-reaching structural reforms in the early 1990s. The first comprehensive structural reforms of Germany's socio-economic institutions, on the other hand, were carried through only ten years later in the early 2000s.

Why do countries not promptly adopt structural reforms that raise – or are, at least, generally expected to raise – aggregate social welfare? This empirical puzzle has been identified as one of the fundamental questions of rational choice political economy (Fernandez & Rodrik 1991). If change to the institutional structure of the economy is expected to raise aggregate welfare, winners of the institutional change should be able to compensate losers; institutional change should be possible. The 1990s saw the emergence of a formal political economics literature on reform inertia. In general, models in this literature rely on uncertainty and asymmetric information to explain the persistence of a welfare-inferior status quo. Fernandez & Rodrik (1991) show, for example, that if the distribution of costs and benefits of a reform is uncertain, a majority of risk-averse individuals may block a reform *ex ante*, which would be approved *ex post* (Laban & Sturzenegger 1994, for a similar model). Alesina & Drazen (1991) demonstrate how welfare improving reforms may be delayed in a war-of-attrition model if there is asymmetric information over the cost and benefits of the policy measures.

Unfortunately, the prevalent rational choice models on reform inertia are limited in their ability to explain the reform trajectories in Europe. First, these models typically set out from a strong normative assumption about the desirability of a particular, typically supply-side reform policy. They take no account of the particular political, economic and social institutional arrangements in European countries. These institutional arrangements, however, have important repercussions both for the welfare effects of reforms as well as for the political economy of the reforms. Second, the models typically seek to explain biases towards an institutional status quo. They have little to say about institutional change in the absence of severe exogenous shocks. Reform trajectories in Europe are, however, characterised by episodes of both puzzling inertia and reform.

This paper develops a rational choice model to contribute to the understanding of both episodes of institutional stability and change in continental European countries, taking into account their distinctive politico-economic institutions. Building on the comparative capitalism literature, the paper begins with the supposition that, within Europe's 'coordinated market economies', elements of the European socio-economic model complement each other in a way that supports a particular type of – potentially highly productive – industrial regime. It argues, however, that these institutional complementarities tend to benefit some 'inside' sectors in the economy more than others. At the same time, corporatism typically grants stakeholders from the inside sectors strong political influence, biasing the policy-making process towards their interests. Policy continuity and change in this model is thus driven by an interest group logic (Olson 1982), rather than by uncertainty or asymmetric information.

To the best knowledge of the author, the model in this paper presents the first attempt to capture institutional complementarities, the central mechanism underlying a coordinated market economy, in a purely rational choice framework. It thus provides a 'equilibrium-functionalist' rather than a 'historical-political' rationale for the existence of complementary institutions (Deeg 2007). More specifically, most of the relevant comparative capitalism literature – while assuming rational socio-economic actors – broadly takes institutional complementarities as exogenously given; as 'constraints that shape human interaction' (North 1990, 3). By contrast, institutions in this paper are conceived at a higher level of abstraction and as 'collective constructs' (Hall & Thelen 2009), which are sustained by equilibrium behaviour of socio-economic actors.[2]

[2] Note that institutions conceive as 'equilibrium ways of doing things' (Shepsle 2006) emphasises the societal consensus necessary to sustain a (set of) institutions, while downplaying their formal and binding character. The introduction and conclusion to this PhD project provides a more detailed discussion of different approaches to conceptualising institutions. As a consequence, institutions and coordination become synonymous in this paper's model, while the prevalent comparative capitalism literature distinguishes between coordinating institutions and the coordination process itself.

This rational choice approach to modelling institutional complementarities advances the understanding of reform trajectories in Europe's coordinated market economies in several ways. First, it provides an argument for why countries may retain socio-economic institutions that do not or no longer maximise aggregate welfare, even if these institutions are assumed to be fully under the control of rational actors with perfect information. Second, modelling coordinating institutions as a 'fragile' equilibrium allows institutional change even in the absence of large exogenous shocks. While the institutions of a coordinated market economy are self-enforcing in that complementarities mutually increase their value to actors, the model shows that relatively modest shifts in socio-economic variables may destabilise this type of economic model and induce structural reforms. Third, the model also gives some indication on the role of government in procuring complementary institutions and its motivation for enabling economic coordination. Fourth, the model points to a number of socio-economic variables that may be expected to significantly determine institutional stability and change in a coordinated market economy.

The paper is organised as follows: For the benefit of readers unacquainted with the relevant comparative capitalism literature, Section 2 briefly summarising the literature on institutional complementarities in coordinated market economies. It then develops this approach by taking into account corporatist arrangements and the role of socio-economic actors – particularly trade unions, employer organisations – as well as the government in shaping these socio-economic institutions. It further extends the original concept of coordinated market economies by a insider-outsider dimension. Section 3 then proposes a formal model, which attempts to capture some of the core elements of these political economies. The section also provides some comparative statics of the model as well as a short discussion on how focal points may lead to adjustments rather than the abandonment of institutional complementarities. Section 4 provides some descriptive indication of the model at work by analysing the reform trajectories of Germany and Sweden. In this way, the paper broadly takes the form of an 'analytical narrative' (Bates et al. 1998). Section 5 concludes and identifies ways forward for possible extensions to the model.

3.2 The argument

Continental European economies have been found to differ significantly from the textbook description of a market economy. In a recent newspaper article, Edmund Phelps describes their differences to the Anglo-Saxon market economy as follows:

> The other system – in Western Continental Europe – though also based on private ownership, has been modified by the introduction of institutions aimed at protecting the interests of "stakeholders" and "social partners." The system's institutions include big employer confederations, big unions and monopolistic banks. [...] Codetermination (cogestion, or Mitbestimmung) has brought worker councils (Betriebsrat); and in Germany, a union representative sits on the investment committee of corporations. [...] What it lacks in flexibility it tries to compensate for with technological sophistication.[3]

In the following section, the paper will discuss the implications of this 'other market economy' with strong stakeholder involvement in the political economy for socio-economic outcomes and institutional change. First, it provides a brief describe the concept of 'institutional complementarity', the institutional foundation of Europe's 'coordinated market economy'. Second, it adds two elements to the conventional description of the coordinated market economy, addressing some common criticism of the original framework. More specifically, the paper argues that corporatist actors can – through their privileged access to the political decision-making process – shape the institutional environment in which they operate. It also argues that institutional complementarities are likely to be shaped for the benefit of these same actors rather than the economy as a whole.

Institutional complementarities

Many continental European economies allow the free operation of market mechanisms to a lesser degree than Anglo-Saxon economies. Instead, government regulation and intervention, and negotiated agreements between socio-economic interest groups replace the market allocation of resources. In the labour market, for example, wages are not primarily set through a supply and

[3] The Wall Street Journal, 10 October 2006

demand mechanism, but are negotiate centrally by firms, trade unions and (in some cases) the government. Blanket wage agreements then cover whole industries. Clearly the 'invisible hand' that is supposed to guarantee the optimal allocation of resources in markets operates to a lesser degree than in most Anglo-Saxon economies. From a neo-classical economic perspective these arrangements are bound to distort resource allocation and lead to welfare-inferior economic outcomes.

Other literatures, however, take a more favourable view of the institutions in continental European economies. Much of the neo-corporatist literature has argued, for example, that economies with corporatist institutions may be more successful in practising real wage restraint than economies with decentralised labour markets (Calmfors & Driffill 1988, Soskice 1990b, Hall & Franzese 1998, Scharpf 1997). Beyond this, both the economic and political economy literature have developed the concept of complementarities between different socio-economic institutions. Generally, institutional complementarities capture the idea that the effectiveness of one institution may be augmented by the presence of another institution and vice versa (Aoki 1994, Amable 2004). This approach allows for the possibility that a set of institutions – while possibly being highly distortional individually – complement each other in such a way that the overall performance of the economy is increased rather than reduced.

In their seminal comparative capitalism contribution, Hall & Soskice (2001) use the concept of institutional complementarities to develop two ideal-type economic models. Different institutional arrangements provide different comparative institutional advantages in strongly regulated 'coordinated market economies' and market-driven 'liberal market economies'.

> The basic idea is that the institutional structure of a particular political economy provides firms with advantages for engaging in specific types of activity there. Firms can perform some types of activities, which allow them to produce some kinds of goods more efficiently than others because of the institutional support they receive from those activities in the political economy, and the institutions relevant to these activities are not distributed evenly across nations. (Hall & Soskice 2001, 37)

The Varieties of Capitalism literature further suggests that the institutional framework in coordinated market economies does not systematically perform more poorly than the market-based arrangements in Anglo-Saxon economies.

Rather, a comparative institutional advantage facilitates the specialisation of these economies in lucrative segments of the global economy. More specifically, several complementarity institutional clusters – the corporate governance and financial system, industrial relations and labour market regulation, vocational training and inter-company relations – in coordinated market economies suggest a specialisation in high-quality production: Rigid labour markets, for example, cause low worker mobility and facilitate the growth of firm-specific skills. Similarly, work representation on plant and company level promotes the flow of information between the management and the shop-floor. Vocational training schemes enable school-leavers to gain experience in their future work environment at a very early age.

The coordination of interests between economic actors is of integral importance to sustain – as the name suggests – the coordinated market economy's institutional complementarities and its comparative institutional advantage. For example, the German vocational training system can only be sustained if trade unions are willing to accept that apprentices are paid well below the coordinated wage agreement, if firms are willing to continue investing in the firm-specific skills, and if the government maintains generous unemployment benefits and employment protection legislation that protects these skills within firms (Esping-Andersen 1990, Hassel 2008).

High returns from institutional complementarities may even reverse the interests of economic actors. It is conventionally assumed, for example, that the business community will oppose welfare institutions because these increase labour costs (wage and/or non-wage) or taxes (Huber & Stephens 2001). Mares (2003, 261) finds, however, that in certain circumstances 'a cross-class alliance comprising large manufacturing producers and the most important sectors of the labor movement' supports the development of welfare institutions, particularly to protect skill formation within firms or sectors.

Based on this argument, the comparative capitalism literature argues that continental European countries, such as Germany, Austria, Sweden and Denmark, have exhibited high growth rates and among the highest per-capita income levels in the world. Institutional complementarities go a long way to explain the less than dismal performance of many highly regulated and coordinated European economies from the early 1950s.

Shaping institutional complementarities

Much of the early comparative capitalism literature takes the socio-economic institutional framework as a given. Hall & Soskice (2001) maintain that firms operate within a historically grown set of institutions, 'whose character is not fully under their control'. That is, socio-economic actors cannot create or change 'the overarching institutional structures of the political economy' and as a result 'institutional structure conditions [...] strategy' (Hall & Soskice 2001, 15). For example, one particular set of institutions may favour a high-quality production strategy, while mass production may be optimal when facing another set of institutions. In other words, the institutional structure largely predetermines the strategy of actors, and the institutional structure will thus prescribe whether the economy emerges as a liberal or coordinated market economy.

First, however, Hall & Soskice (2001) have been criticised for being overly static in their approach to institutions (Howell 2003, Goodin 2003, Morgan et al. 2006, among others). Crouch (2005, 2) writes, for example, that while the Varieties of Capitalism literature introduces 'an extremely valuable corrective to assumptions made in economic theory [...], neo-institutionalism has become rather deterministic.' Recent contributions have attempted to address this problem (Hancké et al. 2008, Trampusch 2010, Howell & Givan 2011, among others). Hall & Thelen (2009) argue that political economy actors do not merely adjust their strategies to given coordinating institutions, but take an active role in shaping and maintaining them. Not only does institutional structure condition strategy, in other words, but strategy also conditions institutional structure.

Indeed, the interest representatives of private, economic stakeholders in coordinated market economies – particularly trade unions and employer organisations – play an integral part in shaping and maintaining the country's institutional structure. For example, they supplement the regulatory role of the state by performing 'independent self-regulation' and 'delegated self-regulation' (Streeck 1999). Self-regulation includes, for example, the wage coordination process between trade unions and employer organisations. Delegated self-regulation most often includes the setting of industry-wide rules, guidelines and codes of conduct. The chamber of commerce and industry, for example, oversees the regulation of the content of the vocational training schemes in some countries.

Second, the original Varieties of Capitalism canon has also been criticised for overemphasising the role of private actors and disregarding the role of the state, particularly also in the context of institutional change (Levy 2006, Schmidt 2008, among others). As legislator and regulator, the state clearly takes a central role in defining and changing the formal institutional structures. Schmidt (2009, 517) notes that the 'state is not just the political economy setting that structures the activities of private political economic actors, [but it] also constructs the politics for reform, constitutes the political institutional setting that shapes the reform process, and can also be the political driver for reform.' Accordingly, recent research – particularly research relating to policy change and structural reforms – has shifted attention back to the role of government politics and takes greater account of 'the central and indispensable role of the state in the process of institutional change' (Howell 2005, 251, Hall 2009, Hemerijck 2012).

When 'bringing the state back in', it should not be overlooked, however, that the political decision-making process in coordinated market economies takes a distinctive shape. More specifically, the typical pattern of decision-making in this type of economy – quite independent of the partisan composition of the government in office (Traxler et al. 2001, 302) – is corporatism (Soskice 1990a). Corporatism can be defined as 'institutional arrangements whereby important political-economic decisions are reached via negotiation between or in consultation with peak-level representatives of employees and employers (or other interest groups) and the state.' (Kenworthy 2003, 11)

The influence of private stakeholders on the legislative and regulatory process extends their influence on the shape and persistence of institutions. In practical terms, corporatism implies that peak-level trade unions and employer organisations – but potentially also welfare associations, consumer groups and even the churches – are continuously and involuntarily included into the political decision-making process both through formal and informal channels. Formal routes of influence are, for example, the tripartite governance of parastatal organisations such as public television stations, labour offices etc. Notably, in the Ghent System the main responsibility for the administration of the welfare funds lies with trade unions rather than the government. More informal arrangements additionally ensure a close interlock between the social partners and the political decision-making process. This traditionally manifests itself in leadership overlaps of parties, trade unions and employer organisations (Hassel 2006).

Overall, it is easy to see that corporatism constrains the scope of action of the government in coordinated market economies.[4] Policies in these 'compounded polities' are devised 'in consultation and coordination with business and labor rather than by state *fiat* (as [for example] in the U.K.'s simple liberal market economy)' (Schmidt 2009, 527f., emphasis in original). Note that this does not *a priori* create a status quo bias into the political economy. Rather, policies are less likely to follow government interests – for example policies that maximise the governments chances of re-election – and are more likely to take account of the requirements of corporatist interest groups. At least to some degree, corporatist interests are likely to guide the hand of the government. Accordingly, Schmidt (2002, 107) refers to the 'enabling state', which contributes to complementarity across formal institutions of a coordinated market economy and facilitates 'economic actors to operate cooperatively and to coordinate the direction of their activities with one another and the state'.

In summary, the institutional structure of coordinated market economies is not, or not entirely, predetermined historically, but is subject to the politico-economic stakeholders; not only peak level trade unions and employer organisations, but also the government. It can thus be expected that institutional complementarities – and with them the comparative institutional advantage of this type of economy – are consciously shaped and sustained by these coordinating actors. Institutional complementarities can be interpreted as 'collective constructs'. This, in turn, implies that 'active support for coordination must be mobilized on a relatively continuous basis from actors who are conscious of [their] limitations as well as the advantages. [In consequence,] the durability of an institution can rest substantially, if rarely wholly, on how well it serves the interests of the relevant actors.' (Hall & Thelen 2009, 12-13)

[4] It should not be left unmentioned that policy-making in coordinated market economies is often further constrained by additional compounding factors, such as coalition governments (as a result of a system of proportional representation), the vertical separation of power (as a result of a federal constitutions) or judicial review by a constitutional court. Among other factors, Germany's federal system and the composition of its federal government resulted in decades of 'reform blockade' (see Paper One of this PhD project). In the 'equilibrium-functionalist' approach to institutional complementarities of this paper these 'veto clusters' do not play an accentuated role, given that complementarities depend more on the willingness of certain actors to coordinate their interests rather than on the ability of veto players to prevent institutional change. Accordingly, additional compounding factors in coordinated market economies are disregarded in the following model for simplicity. Note that they potentially play an important role, however, for example if they prevent the government from implementing adjustments necessary to sustain institutional complementarities.

Insider and outsiders in coordinated market economies

The comparative capitalism literature on institutional complementarity has paid little attention to divisions, and the problem of insiders and outsiders in coordinated market economies. Clearly, a particular set of institutions, while being beneficial to certain sectors of the economy, may be disadvantageous to other sectors. Some sectors may be able to harness institutional advantages to their benefit, optimising their production strategy in a certain production regime, as Vitols (2002) has shown for the pharmaceutical industry in Germany. However, other sectors of the economy will not find this as easy. Small and medium size enterprises, firms active in the non-exporting and in the service sectors, and businesses relying particularly on low and medium-skilled workers may find the institutional framework in a coordinated market economy less appealing. Rather than providing any advantage, the institutional framework may simply add costs to the operation. From the perspective of firms active in non-high-quality sectors of the economy, regulation, coordination of interests and generous welfare institutions may look very much like red tape, overly high wages and high taxes.

In short, established institutional complementarities in Europe's coordinated market economies typically favour high-quality manufacturing firms that employ medium- to high-skilled workers on a long-term basis. Unsurprisingly, this has significant implications for the macro-economy. Because firms in the service or low-skilled sectors are disadvantaged, the corresponding segments of the workforce have found it difficult to gain employment. This may well account for the strong segmentation of the labour market in the coordinated market model.

> The downside of the model is its relative incapacity to generate well paid jobs for all who are willing to work, thus producing problems of long-term unemployment and labor-market exclusion, especially among women and older workers. It is therefore no coincidence that much of the political economy literature [...] is replete with references to insider-outsider divisions. (Iversen & Wren 1998, 516)

It should be noted that this insider-outsider dilemma is not problematic *per se* from an aggregate social welfare perspective. In fact, as long as the benefits of the institutional arrangements to the insiders outweigh the costs to the outsiders, these arrangements can be desirable. Winners can compensate losers. Generous welfare systems in continental European economies could be interpreted as serving this purpose, particularly given that they were geared towards preserving the insider-outsider divide rather then encouraging the reintegration of the unemployed into the labour market (Esping-Andersen 1990). If the costs to the outsiders outweigh the benefits of the institutional arrangements to the insiders, however, then these arrangements are more problematic. In a democratic policy-making system, we would expect structural reforms – adjusting or abandoning the institutional framework of the coordinated market economy – if losers cannot or can no longer be compensated by winners.

In decision-making systems with strong corporatist arrangements, however, this is no foregone conclusion. Rueda (2008, 30) finds that 'before insider–outsider divisions [had] become significant, a central feature of corporatism was its nonexclusive and egalitarian nature [...]. As outsiders become more numerous, however, corporatist arrangements serve to protect insiders, rather than facilitate the integration of outsiders.'[5] Indeed, the political economy literature widely acknowledges that corporatist stakeholders serve the economic insiders more than the economic outsiders: Trade unions represent the interests of the skilled, employed workers more than they do those of the labour market outsiders (Lindbeck & Snower 1989, Saint-Paul 2000). And employer organisations often represent large, exporting corporations more than they do small or service-oriented enterprises (Thelen & van Wijnbergen 2003).

This leaves the question why democratically elected governments act as all-facilitating enabler for the interests of insider groups in coordinated market economies, even if these stand in the way of the overall welfare of the economy. It is generally assumed that political parties typically pursue the interests of their constituents. Left-wing parties in governments are thought to represent labour interests; conservative parties in power are thought to represent business and finance interests. However, the political economy literature has shown that parties are likely to pursue the interests – if and when these interests conflict – of the 'inside' fraction of their constituents rather than the interests of the outside fraction (Häusermann 2008, Rueda 2008, Marx & Schumacher 2013). This is explained, among other factors, by the privileged integration of insider interests in the political sphere through corporatist arrangements.[6]

[5] Welfare losses are less likely if the corporatist stakeholders are all-encompassing in their representation of constituent groups. That is, a loss in aggregate welfare is less likely if trade unions represent all workers, employed and unemployed, if employer organisations take into account the costs and benefits of particular institutions for all firms, and if the government caters for all voters equally.

[6] A closely related finding shows that outside interests – for example the vote of the precariously employed or the unemployed – are more difficult to mobilise (Pontusson &

Thus, left-wing parties in governments are likely to be biased towards the interests of 'inside' workers and conservative parties in power are likely to be biased towards the interests of 'inside' business and finance. Rueda (2008, 12) writes, 'In the presence of insider–outsider conflict, social democratic governments will promote insider policies regardless of the consequences for outsiders.' The same is likely to hold true also for conservative governments. For example, it has been argued that government-funded early retirement schemes introduced by the conservative government of Helmut Kohl helped the German industry shed excess labour in economically difficult times without undermining other important institutional elements of Germany's coordinated market economy (Streeck 2005).

In summary, insiders in the economic sphere – those who benefit from the institutional complementarities of the coordinated market economy – are also 'insiders' in the political decision-making process. It is easily understood how the divided economy in a coordinated market economy in conjunction with strong corporatist arrangements can lead to a welfare-inferior institutional status quo. Economic insiders, who have a strong voice at political level and profit from the cooperative arrangements, will uphold complementary institutions with little or no consideration for the potential costs to the outsiders. If these costs to the economic outsiders, who have no direct influence on the policy-making process and do not directly profit from the institutional arrangements, outweigh the benefits to the economic insiders, the aggregate welfare in the economy is not maximised.[7]

3.3 The model

In the following, this paper will translate the above argument into a game-theoretic model. The main purpose of this exercise to extract a set of socio-economic variables that can help predict the emergence of pressure towards structural reforms and institutional change in Europe's 'coordinated economies'.[8] More specifically, the section begins with a short theoretical examination of institutional complementarities, modelled as equilibrium behaviour in a game of strategic interaction. It applies this insights to a rudimentary model of a

Rueda 2010).

[7] The Annex shows that the 'coordinated economy' may indeed be welfare inferior to the liberal market alternative in the formal model.

[8] Given that the market mechanism is replaced by a coordination mechanism and in conscious delineation from the sophisticated Varieties of Capitalism literature, this model is referred to as a 'coordinated economy' rather than a 'coordinated market economy'.

coordinated market economy. It then derives a set of determinants for institutional stability and change. Finally, it provides some intuition on how the process of institutional adjustment may be conceptualised in the model.

Coordinated economies as a cooperation game

The term 'coordinated economy' implies that agents coordinate their actions to attain a better outcome. That is, economic agents coordinate their interests and shape institutional arrangements as discussed in the previous section. To understand the nature of this coordination in game-theoretic terms, consider the following simple normal form game in Table 3.1.

	left	right
top	1,1	x,0
bottom	0,x	2,2

Table 3.1: A game between player 1 (horizontal) and player 2 (vertical)

Note, first, that for any value of $x < 1$ this game is a simple, so-called 'coordination game'. The game has two Nash equilibria in pure strategies, namely [top;left] and [bottom;right], where no player has anything to gain from changing his strategy unilaterally.[9] Note, however, that if the players can coordinate on playing [bottom;right] their payoffs will be higher than if they play [top;left]. The actions of player one and player two are thus 'strategic complements' (Bulow et al. 1985).[10]

Second, consider a case, in which $1 < x < 2$. While the two Nash equilibria remain, [bottom;right] becomes a risk-dominated strategy. That is, it is easy to see that if player 1 plays top, he will always be awarded with a payoff of at least 1. If he plays bottom, however, there is a risk that the other player decides to play left – maybe due to a misunderstanding. To reach the welfare-maximising equilibrium [bottom;right], players have to be confident about the choice of the other agent. 'In coordination games, the key element is confidence rather than conflict.' (Cooper 1999, 17)

Third, consider a situation in which $x > 2$. This game is a simple, so-called 'Prisoners' Dilemma Game', with only one Nash equilibrium, namely [top;left].

[9] Mixed strategy Nash equilibria are ignored for simplicity.

[10] Definition: A symmetric game with two players that each have payoff function $\Pi(x_i, x_j)$. The choice of x_i and x_j are strategic complements if an increase in each player's own decision x_i raises the marginal payoff $\frac{d\Pi}{dx_j}$ of the other player. In other words, the decisions are strategic complements if the second derivative $\frac{d^2\Pi}{dx_i dx_j}$ is positive for $i \neq j$. The function Π is 'supermodular' (Topkis 1998).

In a single shot game, the welfare-maximising equilibrium is unattainable, as agents each have an incentive to defect. Prisoners' dilemma games are among the most popular in the social sciences because they can capture many real-world situations, in which higher levels of player welfare cannot be attained because of conflicting interests. For example, firms would find it beneficial to fix prices above market level. However, in perfect markets each firm has an incentive to undercut the collusive price, thus taking a bigger market-share for itself ('Bertrand competition').

However, industrial organisation has developed game-theoretic frameworks in which tacit collusion between market participants allows them to overcome this competitive market equilibrium (Friedman 1971, Green & Porter 1984, Rotemberg & Saloner 1986). In a non-competitive equilibrium the firms coordinate their market policy and set the product prices/quantities so as to maximise total profits; they collude to escape competition. The market mechanism is abandoned in favour of a cartel that increases the profits of the firms.

Using the 'Folk theorem', it can be shown that this non-market equilibrium is sustainable in an infinitely repeated game; the prisoners' dilemma can be overcome if agents are reasonably patient. The approach to these 'cooperation games' is simple: actors are assumed to aggregate their future payoffs from the different strategic alternatives. It can thus be shown that a higher level equilibrium is sustainable if the sum of expected future payoffs from cooperating is higher than the sum of expected future payoffs from defecting (Rubinstein 1979).

In short, we can distinguish between coordination and cooperation games. Coordination games have multiple, single-shot Nash equilibria and players have to coordinate on the same or corresponding strategies. Cooperation games, on the other hand, describe 'the strategic situation where collectively all gain from cooperation, but unilaterally a deviation by a player is beneficial to that one individual and costly to the other players' (McCannon 2008). Cooperation is sustainable when individuals forsake short-term welfare to increase their aggregate long-term welfare. Note that the infinite repetition moves the prisoner's dilemma game back closer to the logic governing the coordination game. Here, actions of the agents are again strategic complements and there exist multiple (subgame perfect) Nash equilibria.

Thus, and in spite of its name, coordination in a coordinated market economy is better described as a cooperation game with an infinite horizon than a single-shot coordination game. Interests of the agents are, *ex ante*, antagonistically opposed. For example, firms want to pay workers lower wages, while workers want to increase wages. Governments want to tax workers or firms to pay off their interest groups. Consequently, this paper will model a corporatist, coordinated economy – strategic interaction between trade unions, employers and the government, providing institutional complementarities – along similar lines as collusion games. In fact, political economy literature has used a cartel as a metaphor to describe corporatist arrangements: 'Corporatism can be defined as a cartel of elites that permanently cooperate in spite of different interests.' (Streeck 2005, original in German)

A model of a coordinated economy

Consider first a very simple liberal market economy. In this 'standard economy' (indexed 's'), firms produce goods with a single input, labour, such that the output of the economy $Y_s = F(L)$.[11] Individual, identical firms maximise $f(l) - wl$ by choosing optimal labour input levels (l), given market wages (w). Additionally, firms pay a tax. This tax finances a proportion (γ) of the cost (τ) of a publicly provided private good (T), supplied by the government.[12] This tax can be interpreted as the employer's share to social security, for example. In the liberal market economy, firms thus face a profit function that is dependent on their individual output/revenues (y), paid salaries ($w_s l$) and the social security tax ($\gamma\tau$):

$$\pi_s = y - w_s l - \gamma\tau$$

The labour supply is assumed to be fixed (or completely wage inelastic) so that employment levels remain constant. Changes in labour demand are absorbed by wage adjustments. Thus, equilibrium wage in the liberal market economy is given as $w_s = f'(l)$. Workers in the liberal economy are the only beneficiaries of the publicly provided private good, i.e. the social security system (T). Workers themselves pay for the remaining share $(1 - \gamma)$ of the cost of the social security system (τ). In the liberal economy, workers thus

[11] Capital as a production factor is ignored in this model for the sake of parsimony. Capital letters denote aggregate variables, lower case letters denote individual agents.

[12] Note first the difference between public goods, which are both non-excludable and non-rivalrous (e.g. public safety), and publicly provided private goods, which are state-provided goods that could potentially be provided through the market (e.g. education, social security, day care). Note further that firms, for simplicity and without loss of generality, are assumed to pay a lump-sum tax. A proportional tax on revenue or wages, for example, would not change the results of the analysis.

face an income function that is dependent on market wages (w_s), their share of the social security tax ($(1-\gamma)\tau$) as well as a positive return from the social security system (T)[13]:

$$\epsilon_s = w_s - (1-\gamma)\tau + T(\tau)$$

Finally, government decides, first, on whether it wants to provide T to the workers and, second, how it wants to divide the contributions to the social security system across firms and workers. We assume that conservative governments favour firms and left-leaning governments favour workers. And we assume that the full cost of the social security system cannot be borne by either firms or workers alone, that is $0 < \gamma < 1$. It is easy to see how a partisan government decides: A conservative government will not provide T and will not levy taxes on firms or workers. A left-wing government, however, will provide T and will shift the financial burden to firms as much as possible, such that $\gamma \to 1$. Under a left-wing government, $\gamma\tau$) thus effectively presents a transfer from firms to workers.

In short, the liberal market economy has only one type of firm and worker with a nonexclusive labour market, in which wages are market determined. The government decides whether to to provide a redistributive social security system or not, based on its partisan preferences.

Now consider a coordinated economy. Coordinated economies consist of a coordinated ('inside') and an uncoordinated ('outside') sector (indexed 'c' and 'u' respectively). Firms in the inside sector are represented by a peak-level employer organisations, workers in the inside sector are represented by a peak-level trade union. Firms and workers in the outside sector are not represented by employer organisations and trade unions.[14]

Three agents – employer organisations, trade unions and the government – cooperate on maintaining institutional complementarities. First, employer organisations and trade unions are collective agents that represent the interests of inside firms and workers respectively, for example firms and workers in the manufacturing, export-oriented sector of the economy. Employer organ-

[13] T can, for example, be thought of a function the the size of contributions τ as well as the probability of falling back on social security, which is not modelled explicitly here.

[14] Note that firms and workers are assumed to be identical within the inside and outside sectors. The proportion of firms in the inside sector of the economy is assumed to be equal to the proportion of workers in the inside sector. Also, the size of the inside and outside sectors are assumed to be fixed. These assumptions are not very realistic of course, but are made here to avoid unnecessary complexity.

isations and trade unions determine the contributions of individual firms (q) and the contributions of individual workers (s) towards the complementarities. The contributions of firms may be interpreted as investments into particular production technology to be able to produce high-quality goods. Similarly, worker contributions can be interpreted as investments into firm-specific skills – attained, for example, through a universal vocational training system – to be able to operate this technology. Aggregate contributions from firms and workers are given as $Q = \Sigma q$ and $S = \Sigma s$.

Second, governments also contribute to uphold the complementarities. It is assumed here that the government contribution is a function the social security system (T), which the government can provide for workers.[15] Generous levels of social security have, for example, been identified as pivotal to maintain high levels of firm-specific skills in an economy (Mares 2001, Estevez-Abe et al. 2001).

The institutional complementarities allow the coordinated, inside fraction of the economy (denoted θ) to upgrade its production, such that their output at time t is larger by some coefficient α:

$$Y_{c,t} = (1 + \alpha_t)\theta F(\cdot) \quad \text{where} \quad \alpha_t = g(Q_{t-1}, S_{t-1}, T_{t-1}) \geq 0.$$

Conversely, we assume that the institutional arrangements are costly for the remaining uncoordinated, outside share of the economy (denoted $1 - \theta$), so that their production at time t is reduced by a coefficient β:

$$Y_{u,t} = (1 - \beta_t)(1 - \theta)F(\cdot) \quad \text{where} \quad \beta_t = h(Q_{t-1}, S_{t-1}, T_{t-1}) \geq 0.$$

Several additional assumptions are made: First, the production coefficients α and β are 'supermodular' functions of the contributions to institutional complementarities of inside firms Q, of inside workers S and the government T; this is, contributions are strategic complements. Strategic complements imply that a change in one actor's strategic choice gives the other actors an incentive to move in the same direction. For example, $g(\cdot)$ could be some Cobb-Douglas function, such that $g(\cdot) = aQ^b S^c T^{1-b-c}$. Second, individual contributions of firms (q) and of workers (s) to the institutional complementarities are costly to these agents. Third, contributions made in the previous period $t - 1$ take effect in the present period t.

[15] $T(\tau)$ is a function such that if $\tau_t = 0$ then $T(\tau_t) = 0$.

In summary, institutional complementarities in the coordinated economy are modelled as equilibrium behaviour of employer organisations, trade unions and the government. Their respective contributions create complementarities, which 'upgrade' the coordinated part of the economy. However, the ensuing structure is a costly 'downgrade' for the uncoordinated part of the economy.

Profit and income functions for inside and outside firms and workers in the coordinated economy are derived next. It is assumed that inside firms pay wages to inside workers; outside firms pay wages to outside workers. Wages paid in the inside, coordinated sector are negotiated between the peak-level employer organisation and trade unions and are assumed to be higher than wages in the liberal market model ($w_c > w_s$). Wages in the outside, uncoordinated fraction of the economy are market-determined. Note that – taking into account the negative effect of institutional complementarities on the uncoordinated fraction of the economy – the wages in this part of the economy will be $w_u = (1-\beta)f'(l)$ and thus lower than the wages in the liberal economy ($w_u \leq w_s$).

From the above discussion, the profit functions (π) for individual, identical inside and outside firms, and the take-home income (ϵ) for individual, identical inside and outside workers at time t are given as follows:

$$\begin{aligned}
\pi_{c,t} = &\ (1+\alpha_t)y - w_c l - \gamma\tau_t - q_t \\
\pi_{u,t} = &\ (1-\beta_t)y - w_u l - \gamma\tau_t \\
\epsilon_{c,t} = &\ w_c - (1-\gamma)\tau_t + T(\tau_{t-1}) - s_t \\
\epsilon_{u,t} = &\ w_u - (1-\gamma)\tau_t + T(\tau_{t-1})
\end{aligned}$$

In words, profits are determined for inside and outside firms by their income (y), marked up or down by the production coefficients (α_t and β_t respectively), by the wages they pay to inside and outside workers (w_c and w_u respectively) as well as by the share of the social security system they are required to finance ($\gamma\tau_t$). Also, inside firms need to pay their contribution to uphold the institutional complementarities (q_t). Take-home income of the workers is determined by wages for insider and outsider workers (w_c and w_u respectively), and their share of cost of the social security system ($(1-\gamma)\tau_t$). Both insider and outsider workers benefit from contributions made to this system in the previous period ($T(\tau_{t-1})$). Additionally, inside workers are required to pay contribution to uphold the institutional complementarities (q).

After describing the economic environment in the coordinated economy –

institutional complementarities and an exclusive economy – the paper turns to the strategic choice of the collective agents. At any given time t, firms and workers collectively maximise their profits and their take-home income through the policy choice of employer organisations and trade unions: inside firms set the optimal level of high-technology investment (q_t) though the employer organisations. And inside workers choose the optimal level of skill investment (s_t) though the trade unions.

$$\begin{aligned} \max(\pi_{c,t}) &= \max_q[(1+\alpha_t)y - w_c l - \gamma\tau_t - q_t] \\ \max(\epsilon_{c,t}) &= \max_s[w_c - (1-\gamma)\tau_t + T(\tau_{t-1}) - s_t] \end{aligned}$$

At the same time, the government decides on the existence of the social security system ($T(\tau)$) and the shape of its financing (γ). First, conservative governments will again advance the interests of their constituents, namely firms in the coordinated, inside section of the economy. The government can decide to not maintain a social security scheme. However, setting $\tau_t = 0$ will result in $T(\tau_t) = 0$ and $\alpha_{t+1} = g(\cdot) = 0$. That is, the economy will revert back to a liberal market economy, in which firms profits are given by $\pi_s = y - w_s l$.

In case it decides to uphold a coordinated economy, it will choose γ to maximise the profits of its constituents: It will set γ as small as possible and hence $(1-\gamma)$ as large as possible. However, it has to take into account the participation constraint of the inside worker.[16] That is, the government may not be able set the level of contribution for inside workers too high or the inside workers will loose their incentive to invest in the complementarities and defect from the cooperative equilibrium. The maximisation problem of a conservative government is thus given as follows:[17]

$$\begin{aligned} \max(\pi_{c,t}) &= \max_\gamma[(1+\alpha_t)y - w_c l - \gamma\tau_t - q_t] \\ &\text{s.t.} \quad w_c - (1-\gamma)\tau_t + T(\tau_{t-1}) - s_t \geq w_s \end{aligned}$$

On the other hand, left-wing governments will advance the interests of their constituents, namely workers in the coordinated, inside section of the economy. The maximisation problem of a left government is thus equivalently

[16]Note that the participation constraint may become binding where coordinated wages (w_c) are relatively low *vis-à-vis* wages in the liberal economy (w_s), where $(1-\gamma)\tau_t$ and s_t are large, and/or returns from $T(\tau)$ are low.

[17] Note that it is assumed that governments – conservative or left – remain in power after a regime switch from a coordinated to a liberal economy. Again this assumption is without loss of generality. It can easily be shown that replacing conservative and left-wing government choices of γ with a probabilistic alternative does not change the results.

given as follows and is subject to the participation constraint of the inside firm (where the superscript of e denotes expected contributions to the social security system following a breakdown of coordination):

$$\begin{aligned} \max(\epsilon_{c,t}) &= \max_{\gamma}[w_c - (1-\gamma)\tau_t + T(\tau_{t-1}) - s_t] \\ \text{s.t.} &\quad (1+\alpha_t)y - w_c l - \gamma\tau_t - q_t \geq y - w_s l - \gamma^e \tau_t \end{aligned}$$

Given the assumptions, an equilibrium in this model is determined by the expected profits of inside firms π_c, the take-home income of inside workers ϵ_c as well as their expected profits and income in the liberal economy alternative. Partisan governments – both left and right – take into account the payoff functions of both firms and workers. This appropriately reflects the role of governments as facilitator in coordinated economies.

Note that, at any given point in time, this coordinated economy has some likeness to a prisoners' dilemma game. At time t each agent has a short-term incentive to defect from making contributions to maintaining the institutional complementarities. This would allow the agent to reap the full benefits, for which contributions where made in $t-1$, without incurring the cost of contributing to the institutional complementarities in t. If one of the three agents pays no contribution in t, however, this will leave the coefficient $\alpha_t = g(\cdot) = 0$ as well as as $\beta_t = h(\cdot) = 0$ in the following period $t+1$. As a result, $Y_{c,t} + Y_{u,t} = \theta F(\cdot) + (1-\theta)F(\cdot) = Y_{s,t}$. In short, if the interaction between the three agents – employer organisations, trade unions and the government – took place only once, no coordination would take place and the liberal economy equilibrium would emerge.

Over an infinite horizon, however, there is more than this one equilibrium: Again, agents can decide never to cooperate on the institutional complementarities. The economy will remain to the simple liberal market model as described above. There will be no difference between the profits in the insider and outsider sectors of the economy. Wages of outside and inside workers will be w_s. Left-wing governments will maintain a social security system, conservative governments will not. There is, however, at least one other equilibrium. Even though the prisoners' dilemma setup of the model suggests that coordination is difficult to sustain in the short-term, it can be shown that the supermodular nature of the production coefficients allows a coordinated equilibrium to be sustained in an infinite horizon setting.[18] This equilibrium and

[18] Milgrom & Roberts (1994) show that supermodular games have a largest and a smallest serially undominated strategy for the players. That is, they have at least one 'high' and one

the determinants for its stability will be discussed in the next section.

Comparative statics and determinants for reforms

Institutional change in this model interpreted as deviation from equilibrium. Reforms thus result from instability of a particular equilibrium and, accordingly, on the payoffs that one equilibrium provides to agents *vis-à-vis* an alternative equilibrium. Starting from a cooperative equilibrium, for example, a fall in expected payoffs will make the non-cooperative arrangement seem more attractive. This may prompt agents to question the cooperative arrangement and precipitate structural reforms.

To show this, we assume the coordinated equilibrium is sustained by a simple 'Grim Trigger Strategy'. This strategy prescribes the following actions: 'If all agents cooperated in the last period, my strategy is to cooperate in this period. If any agent defected in the last period, I defect in this and in all following periods.' This strategy is a subgame perfect Nash equilibrium and upholds a cooperative equilibrium if the following condition is met for the employer organisation, the trade union and the government: the sum of all present and future discounted payoffs of cooperating must be larger than the payoffs of defecting today plus the sum of all future discounted payoffs of non-cooperation. For example, for the employer organisation this implies the following.[19]

$$\begin{aligned}\underbrace{\sum_{t=1}^{t\to\infty}\delta((1+\alpha_t)y-w_cl-\gamma\tau_t-q_t)}_{\text{sum of payoffs from cooperation}} \quad &\geq \quad \underbrace{((1+\alpha_t)y-w_cl-\gamma_t\tau)}_{\text{payoffs from defect}} \\ &+ \quad \underbrace{\sum_{t=2}^{t\to\infty}\delta(y-w_sl-\gamma^e\tau)}_{\text{sum of payoffs from non-cooperation}}\end{aligned}$$

Solving the above participation condition for the discount factor (δ) provides the below inequality. The discount factor can here be interpreted as the patience of the agent to wait for future payoffs. The larger δ, the less the agent's discounted future payoffs *vis-à-vis* today's payoff. It follows that the larger the fraction on the right hand side of the inequality, the more patient

'low' Nash equilibrium, similar to the ones in a coordination game.

[19] The symmetrical participation condition for trade unions and the government are omitted for brevity.

agents must be for the below inequality to be true and for the coordinated economy to be stable:

$$\delta_{\text{inside firms}} \geq \frac{q}{\alpha y - (w_c - w_s) - (\gamma - \gamma^e)\tau}$$

In words, the willingness of the employer organisation to cooperate depends negatively on the technology investment (q). It depends positively on the positive revenue differential attained through coordination (αy) and negatively on the wage differential between the wage in the inside, coordinated sector *vis-à-vis* the wage in the uncoordinated, liberal economy ($w_c - w_s$). Finally, the willingness of the employer organisation to cooperate depends negatively on the difference between current social security contributions and those expected in the liberal market economy $(\gamma - \gamma^e)\tau$. Where the current and expected share to the social security contribution are the same ($\gamma = \gamma^e$), the social security system does not impact the strategic decision of firms. It is easy to see, however, that lower expected social security contributions will make the liberal economy economy more attractive *vis-à-vis* the coordinated market economy.

The equivalent participation condition of trade unions can similarly be solved for the discount factor of the insider worker:

$$\delta_{\text{inside workers}} \geq \frac{s}{(w_c - w_s) + (\gamma - \gamma^e)\tau + (T - T^e)}$$

In words, the willingness of the workers to cooperate depends negatively on the skill investment (s). It depends positively on the wage markup in the coordinated economy ($w_c - w_s$). Given that the share of social security contributions not paid by workers is paid by firms, it is easy to understand that the difference between current and expected contributions is included in the function with the opposite sign; a lower expected employer share of social security contributions in the liberal economy ($(\gamma - \gamma^e)\tau$) increases the attractiveness of the coordinated equilibrium for workers. Equivalently, a higher (lower) expected return from the social security system ($T - T^e$) will increase (decrease) the attractiveness of the coordinated status quo. For example, in a situation with a conservative government, a breakdown of coordination would imply the dismantling of the social security system ($T^e = 0$) and the economy reverts to the liberal model.

Finally, we can solve the equivalent participation condition for the discount factor of the government. Again, we take account of the partisanship of the government as well as the participation condition of the 'other' inside group. A conservative government will thus participate in coordination if the following condition is fulfilled:

$$\delta_{\text{right government}} \geq \frac{\gamma\tau}{(\alpha y - q - s) - (1-\gamma)\tau}$$

In words, the willingness of the government to sustain the coordinated equilibrium depends positively on the net value added of coordination, that is, the benefit of the economic upgrade less the cost of coordination to both inside firms and workers ($\alpha y - q_t - s_t$). At the same time, the social security contributions enter the inequality twice. They have a negative effect on equilibrium stability as the numerator and positively as part of the denominator. The 'main effect' in the numerator marks the negative effect of the social security contribution on the profits of the conservative government's constituents, inside firms ($\gamma\tau$). The 'secondary effect' is the positive effect that higher social security contributions for firms have on the income of inside workers ($(1-\gamma)\tau$).

A left-wing government will participate in coordination if the following condition is fulfilled, where variables are interpreted equivalently to the participation constraint of conservative governments:

$$\delta_{\text{left government}} \geq \frac{(1-\gamma)\tau}{(\alpha y - q - s) - \gamma\tau}$$

Note the policy implemented by a conservative government in a coordinated economy resembles the policy of a left-wing government more than that of a conservative government in a liberal economy. Recall that a left-wing government provides social security in a liberal economy, while a conservative government does not. In a coordinated economy, both types of government provide a social security system. Thus, This difference in conservative government policy is explained as follows: The conservative government had no motivation for providing a social security system in the liberal economy, given that it provides no benefits and is costly for its corporate constituents. In the coordinated economy, however, the government has an incentive to provide a social security system because this acts as a complement to the high-tech investment made by firms. The social security system is – from the perspective of the conservative government – transformed from a redistributive tool in the liberal economy into a functional tool for skill-preservation in the coordinated economy. Partisanship as a determinant for policy preferences for socio-economic institutions is effectively reduced.

A quick comparative statics exercise – the comparison of states of the world, before and after a change of an underlying exogenous parameter – allows to draw conclusions on determinants for institutional stability and change in coordinated economies. First, an important determinant for policy continuity and change is the size of the markup (α) through the production coefficient in the coordinated equilibrium. Any exogenous drop in this coefficient – maybe due to reduced demand for the goods produced by the inside sectors – would make the cooperative equilibrium less attractive relative to the non-cooperative equilibrium and increase the likelihood of a breakdown of cooperation. In empirical terms, this would realistically imply that a drop in demand for luxury cars and machine tools in Germany, for example, would increase the probability of a significant overhaul of the country's socio-economic institutions.

Note that economic crisis in a coordinated economy is a determinant for reform if it results in a drop in the markup α, but not if it affects only the markdown β. However, it is easily conceivable, that the economy is hit by an exogenous shock, which predominantly effects the uncoordinated sector of the economy, resulting in a negative change of the markdown (β), for example, and a drop in outside profits and income. More competition through international economic integration, for example, is expected to have a negatively effect predominantly in the outside, mass-production sectors of the economy. The outside, uncoordinated sectors do not, however, play a role in the coordination between employer organisations, trade unions and the government. This explains why coordinated economies can go through extended episodes of growth and employment crises without noteworthy reforms.

Second, it is easy to see that the stability of the system depends on the costs of maintaining the high-quality equilibrium. The smaller the net benefit of coordination for the inside sector of the economy ($\alpha y - q_t - s_t$), the more difficult it is to sustain coordination. These costs are, in particular, the technology investment costs incurred by the insider firms (q) investment costs incurred by the insider workers (s).[20]

Third, the wage markup of workers in the inside sector has an ambiguous effect. Greater wage differentials will reduce the employer's incentive to stick to the cooperative equilibrium, while increasing the worker's incentive to maintain the cooperative equilibrium. To sustain the cooperative equilibrium,

[20] In a sense, contributions to the social security scheme could also be interpreted as 'investment cost' of the high-quality equilibrium, given that the motivation of the social security scheme is not – as is the case in the liberal economy – primarily redistributive, but rather a functional tool to sustain the coordinated equilibrium.

the wage differentials may neither be too large nor too small. This follows the same simple logic, put forward by Schmitter (1989) on the stability of a coordinated wage bargaining system: 'When the labour market is tight, capitalists see formally hidden virtues in corporatist compromises which encourage wage restraint; inversely, when it is loose, trade unions find that they can use these same arrangements to protect the concession they managed to extract previously. The temptation to defect is greatest for both at the zenith and nadir of the cycle.'

Fourth and finally, the effect of changes in the social security system on the stability of the coordinated economy broadly also has an ambiguous effect. On the one hand, an increase in the costs to the social security system (τ) is likely to reduce the stability of the coordinated equilibrium and increases the probability of reform.[21] The effect of a change in distribution of costs of the social security system on equilibrium stability is, on the other hand, more ambiguous. An increase (decrease) of γ will both raise (reduce) cooperation incentives for firms and reduce (raise) cooperation incentives for workers.[22]

Institutional adjustment and focal points

The above has provided a model of a coordinated market economy as a cooperative equilibrium in a repeated game of strategic interaction using the Folk theorem. Institutional change in this model occurs when one or more agents defect from the cooperative equilibrium. In this case, the model returns to its baseline, non-cooperative equilibrium; the economy switches from a coordinated to a liberal market economy.

There is, however, little observable evidence of the transformation of coor-

[21] Note that τ has a negative effect on the participation constraint both of the inside firms and workers.

[22] The government will reduce the contribution share of its constituents and raise the share of the other group. Recall, however, that governments may be constrained in the degree to which they can pass on the cost of the social security system to non-constituents. While a conservative government in a coordinated economy will want to reduce corporate contributions ($\gamma \to 0$), it will be constrained by the participation constraint of inside workers. Vice versa, left-wing governments in a coordinated economy will want to reduce worker contributions ($\gamma \to 1$), but will be constrained by the participation constraint of inside firms. Thus, not only does the coordinated economy in this model align the policies of conservative and left-wing governments in providing a social security system. So some degree, it may also align the way the financial burden of this system is divided on employers and workers. Note that, where the operating surplus of inside firms ($(1 + \alpha_t)y - w_c l$) is relatively small under a left-wing government, workers may shoulder more of the cost of the system to uphold the coordinated economy. Equivalently, where the gross income ($w_c + T(\tau_{t-1}) - s_t$) of inside workers is relatively small under a conservative government, firms may shoulder more of the cost of the system than workers.

dinated market economies into liberal market economies. Rather, coordinated market economies tend to adjust institutions to maintain their institutional complementarities. Hancké et al. (2008, 13) find that 'countries in Europe have [...] altered their institutions in the face of domestic challenges and changing international conditions, but those changes have been strongly conditioned by past institutions and underlying complementarities have been maintained'.

This observation can be accommodated for in the model presented in this paper by allowing for renegotiation after a departure from the cooperative equilibrium. Indeed, after one or more agents have defected, there is – from a rational choice perspective – no reason that agents cannot return to a new cooperative arrangement.[23] The problem here is not that no new cooperative equilibrium can be found. Rather, there may be a large number of new ways in which cooperation could be sustained. Indeed, 'if cooperation is sustainable at all there will normally be an infinite number of equilibria. Therefore, making [a prisoner dilemma-type] game repeated is not necessarily a way of escaping its conflictual nature' (Leeson et al. 2006, 139). By itself, the model cannot predict what happens after a departure from the status quo, that is, a breakdown of the cooperative equilibrium. In practical terms, there may be a significant number of configurations in which institutions complement each other to sustain a coordinated market economy. Indeed, none of the coordinated market economies exactly resemble another.

Given that coordinated market economies look back on a long history, however, the previous institutional equilibrium is likely to provide a starting point for the renegotiation between agents. Such a starting point for negotiation is known as a 'focal point' in game-theoretic terms. In his seminal game-theoretic contribution, Schelling (1980, 57) finds that while formal game theory does not allow for such, most real life situations 'provide some clue for coordinating behavior, some focal point for each person's expectations of what the other expects him to be expected to do'. They are a type of universally appreciated 'label' that guides coordination or cooperation behaviour.[24] Thus, a new cooperative equilibrium in a coordinated economy is likely to be one that resembles the previous equilibrium quite closely – making some adjustments

[23] Note that the 'Grim Trigger Strategy' used in the above model prescribes a permanent return to the non-cooperative equilibrium as a deterrence to prevent a defection by one of the agents. This strategy provides a subgame perfect Nash equilibrium and is sufficient to sustain cooperation if it is credible. But it does not preclude the possibility of renegotiation after one or more agents actually defected from the equilibrium.

[24] Schelling's most famous example of a focal point is the 'universal' meeting point in Manhattan; the information booth at Grand Central Station.

for the grievances of the defecting actors.

Note that focal points have a strong behavioural or sociological element and cannot easily be modelled formally (Binmore & Samuelson 2006). The following section will show how a temporary breakdown of the cooperation between relevant agents in Sweden and Germany resulted in structural reforms and substantial institutional change. Both countries, however, seem to have settled comfortably for a new, somewhat adjusted coordinated model after their departure from the original 'Swedish model' and the original *Modell Deutschland*.

3.4 The narrative

Two phenomena would provide some indication for the conjecture that the above model correctly describes the mechanism underlying reform inertia in corporatist economies: first, we would expect to see periods of relatively poor overall economic performance without major reforms. During these periods structural reform initiatives of the government or other political actors would be discouraged or openly blocked by corporatist stakeholders. Second, we would expect to find that if and when major structural reforms are implemented, these are preceded by a significant fall in the payoffs for one or more insider agents and a breakdown of consensus on the prevalent institutional structure.

The paper turns to Germany and Sweden as examples, two countries with deep-rooted corporatist institutions. Both have experienced periods of modest GDP growth and relatively high unemployment. More precisely, Germany has commonly been identified as an underperformer in these terms for much of the 1980s and 1990s; Germany's GDP growth was below that of its OECD counterparts throughout most of this period. As a result, between 2000 and 2002, income in Germany fell behind that of its neighbours – France, the United Kingdom, the Netherlands and Austria – for the first time since the 1950s.[25] Unemployment rose sharply from below 4 percent in the 1970s to almost 10 percent in the late 1990s. Sweden was in a similar situation to Germany thoughout the 1980s. 'Sweden was overtaken by 12 other OECD countries between 1970 and 1995, and wound up with a level of per capita GDP considerably below the OECD average.' (Lindbeck 1997, 1288)

Structural reforms were on the political agenda in Germany from the early

[25] GDP per capita in PPP, own calculations based on OECD Economic Outlook 2009

1980s. However, in spite of the radical reform rhetoric of the Helmut Kohl's government, few liberal policies were implemented in the 1980s or early 1990s (see Paper One of the PhD project). Germany became known as the 'blocked republic'.[26] While much of the academic literature blames German federalism, the trade unions and social interest groups, it has been established that the government's attempts to discard Germany's socio-economic institutions were also foiled by employer organisations, representing particularly the interests of the large export-oriented firms (Wood 1997, Thelen 2000). Wood (2001, 388) finds that 'government overtures to increase the strategic flexibility of employers were rejected. Employers remained wedded to the institutional incentives "high-skill/incremental innovation" production [...] and committed in particular to maintaining the collective strength of trade unions and the long-term security of their workforce.'

Again, similar to the German case, Swedish corporatism – based on the 1938 'Saltsöbaden Agreement' – was built on 'the implicit "cooperative contract" between labour and capital' (Lindbeck 1997, 1293), giving the socio-economic interest groups strong representation in administrative and judicial government agencies. These interest groups were dominated by the export-oriented industrial and engineering sector. The central component of the 'co-operative contract' was wage moderation. 'Export-oriented big business was keen on hindering the sheltered sector from pushing wages up to levels incompatible with international competitiveness.' (Berg & Traxler 2007, 301) Additionally, large, export-oriented firms were rewarded with government subsidies for their employee-friendly conduct and, from the late 1960s, excess labour was absorbed through public employment (Lindbeck 1997).

It is worth noting that, while the coordinated market arrangement in Germany and Sweden was beneficial for the export-oriented industrial and engineering sector, it is not clear whether and how far this arrangement was optimal for the aggregate economy. The number of workers employed by the service sector rose from 40 percent in 1963 to 65 percent in 2003 in Germany and from 46 percent to 75 percent in Sweden over the same time period (Hall 2008, 67). The structural change in Germany and Sweden mirrors that of the United Kingdom, an economy that has practically given up its industrial and engineering sectors. The rise of the service industry implies that the industrial and engineering sector is becoming less relevant to most European economies. This, in turn, is an indication that the 'coordinated economy' may have become

[26] Der Spiegel, 21 September 2002

welfare-inferior.

Following periods of relatively low economic growth and high unemployment, both Germany and Sweden did implement significant structural reforms. Sweden's major socio-economic overhaul took place in the early 1990s. After a short boom in the early 1990s, the country experienced a deep recession in 1993, from which it emerged following some drastic changes to the political system introduced by the Swedish government under the conservative Prime Minister Carl Bildt. The pension system was changed to become a mixed contribution, private fund and public minimum system. The central bank was made independent and monetary policy was geared towards inflation targeting. Fiscal policy became rules-based and the marginal tax rate was reduced. Finally, changes to the security system significantly reduced the number of sick days taken (Lindbeck 1997).

In Germany, structural reforms followed a decade later. After reunification, the conservative government of Helmut Kohl attempted reforms of the labour market and welfare institutions in the second half of the 1990s, but ultimately failed due to the resistance of Germany's strong veto clusters. A few years later, however, the social democratic government of Gerhard Schröder successfully introduced more far-reaching changes to the German economy. Most prominently, the Agenda 2010 policies of 2003 – a bundle of socio-economic reforms that comprised measurements in the labour market, the social security system, the tax system and the research and education system – has been described as 'the most ambitious [reform] seen in post-war Germany.'[27]

What then determined the end to the reform inertia in Sweden and Germany? Both instances of structural reform were linked to a slowdown in world economic growth – due to the 1992/1993 European recession, and the 2001 bursting of the ICT bubble respectively – and a subsequent fall in demand for high-quality, industry and engineering goods (αy). Indeed, the slowdown in demand for exportable goods might have contributed to reform pressure in Germany and Sweden. However, while short-term drops in demand for export goods may have been a catalyst, these can hardly be the main cause for defection of insider firms from the cooperative equilibrium. Forward-looking agents will anticipate a resurgence of demand for industry and engineering products after a global slowdown and refrain from 'throwing out the baby with the bath water' by dismantling the coordinated economy. Indeed, even severe economic crises in Germany in the early 1980s and the early 1990s did not immediately

[27] The Economist, 18 December 2003

lead to structural reforms.

Rather, cost factors in the profit function of employers contributed to the erosion of payoffs for employers in Germany, ultimately leading to their rejection of the cooperative status quo. In particular, mounting social expenditure following German reunification meant that Germany's employers had to shoulder an ever greater burden both in terms of taxes as well as in wages. Non-wage labour costs rose from below 30 percent of overall wage costs in the early 1990s to well over 40 percent after 2000. In terms of the model, this can be interpreted a significant rise in contributions to the social security system ($\gamma\tau$).[28] The first signs of discontent among the employers emerged in the mid-1990s, surfacing in conflicts between large and small firms. While large firms were able to relocate labour intensive production abroad or pass on the costs to their suppliers, small and medium-sized firms were suffering from the rising costs (Thelen & van Wijnbergen 2003). By the early 2000s, however, an overwhelming number of firms and employer organisations saw Germany's socio-economic institutions as a burden rather than an asset for their business operations. Subsequently, the Agenda 2010 reforms introduced by Gerhard Schröder – who maintained good contacts with the executive boards of Germany's large corporations – were significantly shaped along the lines of corporate interests.

While the structural reforms in Germany were largely induced by the fall in payoffs for insider firms in Germany, the cause for the breakdown of the coordination in Sweden in the early 1990s was largely due to changes to the payoffs for the insider workers. The Swedish 'cooperative contract' between capital and labour, geared towards inter-occupational income equality and initially helping the export-oriented sector to maintain international competitiveness, developed unintended side-effects by the 1970s. By eroding the wage premium on skilled labour, wage equalisation effectively led to the shrinking of the skilled workforce. 'The drastic squeeze of after-tax wage differentials among different skill categories of employers during the 1970s [...] reduced the economic incentives to acquire skills [and led to] a slowdown in the expansion of the supply of educated labour' (Lindbeck 1997, 1282). In terms of the above model, the ratio between the wage premium for skilled workers ($w_h - w_s$) was too small *vis-à-vis* the cost of acquiring these skills (s), leading inside workers to defect from the cooperative equilibrium. By the early 1980s Sweden's industry was thus suffering from severe skills shortages.

Though the insider workers stopped investing in skills, it was the Swedish

[28] Own calculations based on DESTATIS data

insider employer organisations that called for reform, particularly regarding the wage bargaining system. In 1983 the engineering employer organisation (VI) pulled out of the centralised wage bargaining system and subsequently offered its staff wage increases above the general collective agreement. By 1990, and after having regained control over the central Swedish employer organisation (SAF), ‘the engineering employers ultimately set about dismantling the system’ (Swenson & Pontusson 2000, 103). The SAF effectively withdrew from all central wage negotiations and the corporatist institutions, making a continuation of the ‘Swedish model’ practically impossible (Martin 1995, 280). Following the deep economic crisis of 1993, the employers supported the reform policies of the conservative government.

In Sweden as well as in Germany, the reforms of the 1990s and early 2000s have significantly changed the countries’ socio-economic institutions. In neither case, however, have the changes led to a complete deregulation of the economy towards the liberal market model. Rather, in Sweden the reform seems to have been a readjustment of the economy’s institutional complementarities, geared particularly towards improving the competitiveness of the export sector. Indeed, the economic performance of Sweden since the mid-nineties has been ‘impressive’ (OECD 2005, 19). In Germany, the Agenda 2010 reforms seem to have unfolded similarly benevolent effects, with growth levels seeing significant improvements and unemployment levels gradually falling from the second half of the 2000s onwards.

3.5 Conclusion

This paper has presented an explanation as to why the European socio-economic model may be biased towards a status quo in spite of strong socio-economic pressure to reform. It argues that this observation is closely linked to the particular nature of Europe’s coordinated market economies. More specifically, this type of economy builds heavily on complementarities in its institutional setup that provide particular sectors of the economy with a strong comparative institutional advantages. As ‘collective constructs’, these institutions are subject to being shaped and adjusted by socio-economic stakeholders – particularly employer organisations and trade unions – in close cooperation with the government. At the same time, corporatism and the implied close integration of privileged stakeholder interests in the political decision-making process results in institutional arrangements that may serve these particular groups more than they do the wider economy. Institutional stability and change then depends on the expected benefits that a set of institutions provides these corporatist actors with, relative to an alternative set of institutions.

A formal version of this argument has provides a rational choice intuition for how conflicting political economy interests are reconciled in a coordinated market economy. The model suggested a number of determinants for policy continuity and change in this type of economy. These are, first, the net additional returns that firms can expect from institutional complementarities, second, the cost of maintaining these complementarities, third, the wage differentials across sectors of the economy, in particular also the wage markup that 'inside' workers can expect in a coordinated economy, and fourth and finally, the design of the social security system. Additionally, focal point theory contributes to explaining why coordinated economies adjust complementary institutions if and when the need arises rather than dismantling them altogether.

A brief examination of Germany and Sweden from the early 1980s to the early 2000s suggests that this model may indeed help explain episodes of institutional stability and change. More specifically, there are strong indications that structural reforms in Germany were significantly determined by the rising costs of the welfare state, borne by the corporate sector. In Sweden, on the other hand, the compressed wage differentials between skilled and unskilled workers led to a defection of the skilled workforce from the coordinated economy, inducing structural reforms.

More generally, the model of a coordinated economy presented in this paper seems to capture the mechanism underlying the interest coordination on institutional complementarities quite well. Some indicative empirical evidence is easily found in its support. The model, however, consciously excludes some important elements of modern European political economies for reasons of parsimony. This, however, limits the model's analytical leverage to address broader questions pertaining to the political and economic behaviour of coordinated market economies. Future versions of this model could easily enhance its sophistication my one or more of the following routes.

First, the mechanism describing the coordination process and institutional complementarities could be enhanced. The model in this paper, for example, does not include capital. However, stable financing is, arguably, the cornerstones of coordinated market economies that has come under most severe pressure in the course of closer European and international economic integration.

Also, the economic interpretation of the institutional complements are broadly exogenous to the model. A more sophisticated model could attempt to endogenise these complements in the production and the labour supply functions of the economy. For example, investment decisions of coordinating firms in high-quality technology could enter the production function twice; as factor for production (together with labour) and as a complementary institution that upgrades the production function (together with, for example, skilled labour, social security, stable financing etc.).

Second, the role of the government in the coordinated market economy could be enhanced. In the current version of the model, governments are unrealistically assumed to only cater for their constituents. It would be more realistic to assume, however, that 'political parties [...] have electoral objectives as well as commitments to ideology and historically meaningful groups of voters' (Rueda 2008, 12). That is, when a political party gains office, it is likely to face a trade-off between providing for its constituents as well as maximising its re-election probability. Future versions of the model could model this trade-off, for example, by allowing the government to choose between different forms of social security, some of which may serve the coordinating interests of its constituents, while others help increase its voter base.

Third, ultimately the model could be enhanced also for macroeconomic analyses. For this purpose, fixed or dichotomous variables in the model – the two types of workers and firms, the level of skill or high-technology investment, and the fixed costs of the social security system – would need to be made variable and continuous. This would allow to analyse, for example, how changes in socio-economic variables change the size, but also income levels in the coordinated, inside and the uncoordinated, outside sector of the economy.

Finally, in terms of empirical findings, the paper has been able to illustrate the function of its model by means of a narrative of the reform trajectories of Sweden and Germany. However, this leaves unanswered the question if and in how far the model has more general significance for European countries with similar corporatist, coordinated systems. These and other questions invite further theoretical and empirical research into the interplay of corporatist agents and the institutional environment in which they operate.

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3.A Welfare analysis

It can easily be shown that the coordinating high-quality equilibrium is not necessarily the social optimum that maximises the aggregate welfare of the economy. Aggregate welfare in the coordinated economy is the sum of income created in the high-quality sector (θ) and welfare created in the standard-quality sector ($1-\theta$). If this sum is smaller than the sum of income when all of the economy engages in standard-quality production, then the high-quality equilibrium reduces the aggregate welfare:

$$\begin{gathered}\theta[(1+\alpha)Y - w_c L - \Sigma(\gamma\tau)] - \Sigma q + (1-\theta)[(1-\beta)Y - w_u L - \Sigma(\gamma\tau)] \\ +\theta[w_c L - \Sigma((1-\gamma)\tau) + \Sigma T] - \Sigma s + (1-\theta)[w_u L - \Sigma((1-\gamma)\tau) + \Sigma T] \leq Y\end{gathered}$$

In words, the above inequality gives the aggregate welfare of the coordinated economy on the left hand side: (1) the aggregate net profits in the inside sector minus the sum of contributions to the complementarities, (2) the aggregate net profits in the outside sectors, (3) the aggregate wages of inside workers minus the sum of contributions to the complementarities, and (4) aggregate wages of outside workers. The aggregate income of the liberal market economy is given on the right hand side. Assuming that the social security system is purely redistributive such that taxes and returns cancel out $\Sigma\tau = \Sigma T$, this inequality can be rearranged:

$$Q + S \geq \theta\alpha Y - (1-\theta)\beta Y$$

In words, the above inequality shows that if the sum of costs of maintaining the coordinated equilibrium (left hand side of equation) is larger than the additional productivity gained from coordination (right hand side of equation), then the coordinated economy does not maximise the overall income in the economy. Please note, however, that the inverse may just as well be true; the coordinated economy may break down even if it provides for an increase in aggregate income for the economy.

Paper 3
Corporatism, the game changer: The intermediating effect of privileged interest representation on the determinants of labour market reform in Europe

Abstract

European countries that were long thought to be inherently biased towards an institutional status quo have in fact exhibited unexpected and significant labour market reform. Conventional theories on the determinants of institutional stability and change fail to fully explain this observation. This paper argues that these theories neglect the intermediating effect of corporatism on the determinants of reform. Using new qualitative data on labour market reforms in Europe, the study interacts a selection of possible determinants for structural reforms with a corporatism indicator. The result of this empirical investigation suggest that employer organisations and trade unions have a significant influence on the labour market reform trajectories in countries with corporatist institutions. At the same time, factors that are conventionally thought to be the drivers of reform – political partisanship and economic crises – have a significant effect on reform trajectories in pluralist countries, but are not significant in corporatist countries.

4.1 Introduction

Up until the 2000s, conventional wisdom held that the European social model – particularly its core elements, the regulation of the labour markets and the generosity of the welfare systems – was resilient to change. In his seminal contribution on the 'new politics of the welfare state' Pierson (2001a, 448) finds, for example, that the European welfare state had 'very modest capacities for restructuring' (Scharpf & Schmidt 2000, Huber & Stephens 2001, for similar arguments). Researchers commonly refer to the large number of veto-yielding actors in the consensus-oriented political systems that stand ready to oppose and effectively prevent change, particularly when and where welfare retrenchment threatens entitlements of the veto players.

More recently, however, this conventional wisdom has been thrown into question. The reform trajectory of labour markets and welfare systems across Europe indicates that institutions are less stable than predicted. Researchers were surprised by recent reforms particularly in continental European countries, such as Germany, Austria and the Netherlands, which were long thought to be particularly resilient to change (Pierson 2001b, Esping-Andersen 1996). In fact, Palier (2010, 19f.) finds that 'all Continental European countries have implemented important structural reforms of their welfare systems.'

In short, institutional reform in continental Europe is today understood to be the rule rather than the exception. As a result, the academic debate has shifted away from explaining institutional stability towards explaining institutional change (Starke 2006). A central problem of this research agenda is the question as to what determines the reform trajectory – particularly the highly controversial cutback of welfare entitlements – in countries with closely interlocking socio-economic institutions and a high number of veto points.

Conventional determinants of structural reforms cannot easily account for the reform paths observed in Europe. It has been argued, for example, that exogenous factors, such as international economic integration or demographic change, put pressure on the institutional structure of a country (Schwartz 2001). However, the conventional wisdom on the resilience of the European social model emerged precisely because of institutional inertia in the face of exogenous pressures. Many European countries, including Germany and Italy, for example, exhibited a high degree of institutional stability even when faced with persistently high unemployment rates and severe economic growth crises. Unresponsiveness to exogenous socio-economic factors seems to be a distinguishing feature of European labour and welfare institutions.

Similarly, the explanatory power of partisanship politics for reform policies in Europe is limited. Generally, government partisanship is expected to matter for reform policies – beyond simple ideological inclinations – because of the strong distributional effects of labour market and welfare institutions. According to this logic, conservative governments would generally be expected to pursue welfare retrenchment, while labour governments are expected to pursue policies of 'decommodification' in the labour market, each catering to their respective constituents (Bradley et al. 2003). In Europe, however, a number of traditional social-democratic governments embraced a market-oriented reform agenda particularly in the 1990s and early 2000s, for example, in the Netherlands and Germany (Schelkle et al. 2010). Generally, partisanship politics does not seem to be consistently correlated with particular labour market and welfare reforms in Europe.

This paper argues that these inconclusive observations are explained by the intermediating effect of corporatism on reform determinants in Europe. Conventional determinants for structural reforms – economic crisis and government partisanship, for example – can be expected to take effect in regular, pluralist European political economies. In a neo-corporatist political economy, however, a particular form of politico-economic interest organisation and privileged form of political interest representation intervenes between broader economic and political pressures and reform policies. Corporatist interest organisation and representation change the political economy game. To understand reform trajectories in European countries, distinguishing features of their political economy have to be taken into account.

In corporatist political economies, the tight interlock or 'integration' (Siaroff 1999) of organised interests – particular trade unions and employer organisations – allows these stakeholders to project their institutional preferences into the policy-making process more continuously and effectively than in a pluralist system. To some degree, corporatist agents override the political decision-making process, rendering factors such as general macroeconomic conditions or partisan rifts of secondary importance. The policy outcome is thus expected to significantly depend on the interest of the corporatist actors. When corporatist interests favour the institutional status quo – despite broader economic and political pressures for reform – this may result in 'institutional stickiness' or blockade, as is commonly predicted (Pierson 1994, 1996, Bonoli 2001). At other points in time, however, corporatist interests may favour institutional change. Because interests of corporatist agents can change over time, this approach to understanding institutional reform in Europe allows for episodes of relative institutional stability and episodes of structural reforms.

Building on the broader political economy literature, Section 2 develops testable hypothesis on the impact of politico-economic factors on structural reforms in corporatist and pluralist European countries. Section 3 provides a detailed discussion of the data used in the empirical study. It shows that corporatist European countries have not enacted less structural reform to the unemployment benefit system than pluralist countries. Section 4 specifies and discusses an empirical model. Section 5 discusses the results of the regression analysis: First, evidence suggests that corporatist interests do indeed have a significant effect on the likelihood of structural labour market reforms in corporatist countries, while they do not have this effect on reforms in pluralist countries. Second, some of the conventional determinants for structural reforms – government partisanship and GDP growth crises – have a significant effect on the prevalence of structural reforms in pluralist countries, but not in corporatist countries. Section 6 concludes.

4.2 Theoretical argument

Labour markets are shaped by a large number of institutions. These institutions include legislation and regulation that directly affects the workforce in employment, such as employment protection legislation, the wage bargaining system, work councils and minimum wages. They also include regulation that is *ex ante* targeted towards the workforce without employment, but affects their working environment nonetheless, such as unemployment benefits, retirement schemes and family policies.

To show how corporatist interests affect labour market reforms across corporatist and pluralist Europe, this paper will focus on the unemployment benefit system. This institution offers itself for analysis because it has a defining influence on labour markets across Europe. The generosity and design of the benefit system impacts work incentives both of workers with and without a job as well as employment incentives of firms. In contrast to other labour market institutions, such as work councils or minimum wages for example, to varying degrees all European countries have some system of support for citizens that lose their workplace.

The following section develops four testable hypotheses on how the interests of corporatist actors are expected to affect unemployment benefit system reforms in corporatist countries and how other economic and political factors – more specifically, political partisanship and economic crises – are expected to matter for reforms in pluralist countries.

The role of privileged interests in corporatist European countries

Although 'corporatism' is one of the most thoroughly studied concepts in the research of Western Europe, the understanding of the concept remains very broad (Molina & Rhodes 2002). With some stylisation, two broad approaches can be distinguished: First, among political economists corporatism is understood as a particular system of economic interest organisation – particularly of workers and employers into trade unions and employer organisations – that impacts on macro-economic outcomes such as inflation, growth and employment. Second, among democracy theorists corporatism is understood a system of interest representation and a process of democratic policy-making. Irrespective of the different strands in the corporatism literature, however, corporatism implies that interest organisation and interest representation provides these interests with privileged access to the policy-making process. Thus, 'important political-economic decisions are reached via negotiation between or in consultation with peak-level representatives of employees and employers (or other interest groups) and the state' (Kenworthy 2003, 11).

The archetypical corporatist actors in Europe are trade unions and employer organisations.[1] They share some important common features. First, in corporatist countries both trade unions and employer organisations are typically integrated vertically in peak associations, although the level of cohesion varies across countries and across time. This coherent aggregation of labour and business interests in a single, peak association is of central importance for the effective representation of interests in the policy-making arena. Competition of different business or labour interests for political control would undermine their political credibility and power (Schmitter & Streeck 1981, Schmitter 1982).

Second, peak level trade unions and employer organisations do not commonly represent the interests of all businesses and all workers equally, but are

[1] Other interest groups, such as welfare or environmental organisations, can also be potent corporatist interest groups. They are not part of this empirical study for two reasons. First, the influence of other interest groups varies more widely across European countries. Second, the objectives of other interest groups are more diverse and (even) more difficult to capture than those of trade unions and employer organisations.

typically dominated by the manufacturing sector (Crouch 2006). To a degree, this is historically determined. The size of the manufacturing sector relative to the services sector has shrunk over the recent decades in all European countries. However, the influence of management and work council representatives from the manufacturing sectors in the executive structures of trade unions and employer organisations has been retained. Additionally, the manufacturing sector is typically more exposed to international trade than the service sector. Following the logic of collective action, this sector has a stronger interest in shaping the institutional environment to suit its needs (Soskice 1999). Thus, 'the stronghold of all encompassing peaks is manufacturing' (Traxler et al. 2001b, 55). And in spite of the gradual shift from manufacturing to services in Europe, this influence has not waned. Traxler & Brandl (2010) finds that the relative power of the exposed sector (typically manufacturing) *vis-à-vis* the sheltered sector (typically the services and government sectors) within the peak trade unions and employer organisations remained constant (e.g. Austria and Sweden) or increased (e.g. Germany) in all European corporatist countries (with the exception of Belgium).

Peak employer organisations and trade unions can be expected to use their influence in the policy-making process to maximise the utility of their constituents. In view of the above, these are firms and blue-collar workers in the manufacturing sector respectively. For firms in the manufacturing sector, it may realistically be assumed that their interests are congruent with those of their owners or stockholders, and thus primarily a function of the firm's profits. The management of a company will attempt, on the one hand, to maximise turnover, while, on the other hand, keeping expenses – investment, input and wage costs, but also taxes and non-wage labour costs – at a minimum. Correspondingly, a peak employer organisation's utility will be a function of the profitability of the manufacturing sector.

The utility of a representative manufacturing worker is somewhat less easily determined than that of a representative manufacturing firm. It is commonly assumed that two important components of his or her utility function are the real take-home wage as well as his job and income security. Assuming a downwards-sloped labour demand curve, trade unions thus face a trade-off between wages and job security. To take account of this trade-off, Layard & Nickell (1990) suggest a probabilistic utility function: the overall utility for a representative union member is calculated by weighing the utility of being employed and the disutility of being unemployed with their respective probability. Mares (2006) similarly suggests defining trade union utility as an inflation-corrected sum of net wages to union members with employment and transfers to union members without employment.[2]

Against the background of these stylised utility functions of manufacturing firms and workers, it is possible to develop expectations of the interests that trade unions and employer organisations will pursue with respect to labour market institutions in general or the generosity of the unemployment benefit system in particular.

Conventionally, employer organisations are expected to be in favour of retrenching unemployment benefits. It is easy to see why this is true in a simple, purely wage-determined labour market model. Unemployment benefits provide workers with an 'outside option' and thus set a minimum reservation wage, below which workers are usually unwilling to accept a job. Lower unemployment benefits reduce the reservation wage in the workforce, allowing employers to squeeze wages. At the same time, the benefit system typically presents costs in the form of taxes or contributions to social insurance. Lower unemployment benefits reduce these non-wage labour costs and taxes.

However, preferences regarding unemployment benefits of employers are in fact likely to be more complex, particularly in Europe's quality-oriented and skill-reliant economies. Political economists have argued that retaining skilled labour is of pivotal importance for manufacturing firms in Europe's 'coordinated market economies', a type of economy that is closely related to or even dependent on corporatist institutions (Soskice 1999, Hall & Soskice 2001). Sufficiently high wage replacements were important to provide workers with income security to incentivise them to invest time and effort in developing highly specialised skills (Mares 2001). More specifically, Estevez-Abe et al. (2001, 152) argue as follows:

> A high replacement ratio, especially when the unemployment benefits are earnings-related, rewards the worker for his or her specific skill investment even when the worker is out of work. A high replacement ratio also eliminates the downward pressure on specific skilled wages, as unemployed skilled workers do not have to take job offers at discounted wages. Benefit duration and the administration of requirements to accept a 'suitable job' further reinforce this mechanism. [...] In short, these two components of unemploy-

[2] Mares (2006) also includes social services, such as public works, security, schooling, health care etc., in the utility function, which are omitted here for simplicity.

ment protection – a high replacement ratio and 'secure' benefits – guarantee return on skill investment sufficient to compensate for economic fluctuations.

Accordingly, the preferences of quality-oriented manufacturers and their respective representative body, the employer organisation, regarding unemployment benefits are less clear cut in coordinated market economies than a simple economic market model would suggest. They are characterised by a trade-off between the need to maintain specific skills in the workforce on the one hand and low taxes and non-wage labour costs on the other hand.[3] Assuming convex indifference curves, employer organisations will balance considerations for skill-formation and non-wage labour costs. This implies that manufacturing firms are more likely to benignly neglect or even support a relatively generous unemployment benefit system in good times, when profits are high. When profits are low or negative, however, the probability increases that costs of the unemployment benefit system outweigh benefits of maintaining high skill-levels.[4] Firms that were not opposed to generous unemployment benefits in 'good times' may find that the burden of non-wage labour costs weigh too heavily on profits in 'bad times'.

Thus, in times of relatively low manufacturing profits, employer organisations will be more likely to withdraw their support for unemployment benefits or even actively pursue benefit retrenchment. At the same time, employer organisations are closely integrated in the policy-making process through in corporatist countries, but not in pluralist countries. Thus, the following hypothesis can be formulated:

Hypothesis 1 *If manufacturing profits fall in corporatist countries, the likelihood of structural reforms that reduce the generosity of the unemployment benefit system significantly increases. If manufacturing profits change in pluralist countries, however, this does not significantly impact the likelihood of reform.*

Turning to the other group of corporatist actors, trade unions are conventionally expected to have exactly the opposite interests of employer organisations regarding the unemployment benefit system. They are thought

[3] The effect of unemployment benefits on the reservation wage are unlikely to matter for the preferences, given that wages in the manufacturing sector of these countries are set according to export competitiveness considerations (see also the argument of preferences of trade unions in coordinated market economies below).

[4] Note that, in times of low or negative profits, manufacturers may also reconsider their high-quality business strategy and their skill-reliant approach.

to generally oppose labour market reforms that reduce unemployment benefits and to be in favour of reforms that increase them; broadly for the same reasons that employer organisations are conventionally thought to oppose generous unemployment benefits. However, as established above, the utility of blue-collar workers – who make up the core of the trade union's constituents – is a function of their job or income security as well as their employment income.

Following the discussion of labour market institutions by Saint-Paul (1996), four channels through which unemployment benefits, in particular, may affect the employed worker can be distinguished: First and most obviously, unemployment benefits – the level of income replacement and conditionality attached to receipts – shape the living conditions of persons without employment. Unemployment benefit are thus included in the insurance component of the employed worker's utility function. Higher unemployment benefits increase the income security in case of an episode of unemployment.

Second, however, unemployment benefits potentially also enter the insurance component of the employed worker's utility function via a second channel, namely by affecting the probability of unemployment. However, the effect of benefit generosity on this probability is not clear cut. On the one hand, employer contributions to social insurance increases non-wage labour costs and reduces labour demand, thus increasing unemployment. On the other hand, a higher reservation wage implied by a more generous benefit system could, for example, reduce competition for jobs from unemployed workers, thus making jobs more secure for the employed.

Third, unemployment benefits – like other labour market institutions – can affect the wage setting for an employed worker. Institutions meant to protect the worker typically also shift the negotiating power away from the employer and towards the worker. This will result in a higher wage share and a lower profit share of the net value added. Higher unemployment benefits, in particular, can be thought to improve the negotiating position of the worker by raising the reservation wage, thus increasing the wages for the employed workforce.

And fourth, unemployment benefits clearly have direct and indirect effects on the level of take-home income of a worker. Unemployment benefits need to be financed. Typically, employed workers pay at least part of this burden via higher income taxes or contributions to the unemployment insurance scheme. Additionally, unemployment benefits can also indirectly affect take-home income, given that higher non-wage labour costs for employers may well depress wages.

The first two channels constitute the 'insurance' component and the latter two channels to the 'wage formation' component in the worker's utility function for the unemployment benefit system. In the particular case of manufacturing workers in Europe's coordinated market economies, the second and third channels – affecting unemployment probabilities and wage formation – play no decisive role for income insurance and wage formation. As argued above, blue-collar workers with a high level of job-specific skills are pivotal to the operation of firms in Europe's high-quality manufacturing sector. This implies, first, that changes in unemployment benefits are unlikely to affect their probability of unemployment. Marginal change in non-wage labour costs are more likely to affect the employment situations of unskilled or temporary workers rather than that of the core workforce. Similarly, the core workforce is unlikely to fear job competition from the unemployed. Second, the level of unemployment benefits is unlikely to affect the wage formation process significantly. Wages for this group of employees are set collectively. They are determined by broader macroeconomic considerations for price stability or export competitiveness rather than by a power struggle between trade unions and employer organisations (Franzese 2001).

The first and fourth channels thus dominate the insurance and wage formation components in the utility function of an employed manufacturing worker and his or her representative body, the trade union: preferences for unemployment benefits will be largely determined by the level of replacement rates as well as the effect of the benefit system on take-home income. It is easy to see, that trade unions – not dissimilar to employer organisations – face a trade-off in determining their preferred level of unemployment benefit generosity. Assuming convex indifference curves, trade unions will balance the insurance and the wage formation component in their utility function. In times of above-trend take-home income, they are likely to be more willing to exchange higher income insurance for part of their current income. Vice-versa, they are likely to be more inclined to forgo the insurance effect of generous unemployment benefits in times of below-trend take-home income.

Particularly in times of relatively low take-home income in the manufacturing sector, trade unions will pursue a reduction in social security contributions. In this situation, they may be more likely to accept or – given their close integration in the policy-making process through corporatist institutions – even actively support a reduction of the unemployment benefit generosity.[5] At the same time, trade unions are not integrated in the policy-making process in pluralist countries. Thus, the following hypothesis can be formulated:

Hypothesis 2 *If the take-home income in the manufacturing sector falls in corporatist countries, the likelihood of structural reforms that reduce the generosity of the unemployment benefit system significantly increases. If manufacturing income changes in pluralist countries, however, this does not significantly change the likelihood of reform.*

The role of political and economic factors in pluralist European countries

The corporatist system stands in contrast to pluralist political systems, in which a larger number of societal interests are thought to compete over influence from outside the policy-making system.

> Pluralism can be defined as a system of interest representation in which the constituent units are organized into an unspecified number of ordered multiple, voluntary, competitive, non hierarchically and self-determined (as to type or scope of interest) categories which are not created or specially licensed, recognized, subsidized, otherwise controlled in leadership selection or interest articulation by the state and which do not exercise a monopoly of representational activity within their respective categories. (Schmitter 1974, 95)

This implies, first, that there are no privileged interests included in the political decision-making process (or, at least, that their influence is weaker). Changes in manufacturing profits and income are not expected to significantly change the likelihood of reform. Second, this implies that policy trajectories

[5] Note that instead of supporting benefit retrenchment, trade unions could attempt to shift the burden of social security contributions to the employers. There are limits to this policy, however, given that it increases the non-wage labour costs for employers. have an indirect negative effect on wages and may ultimately reduce the job security of workers. Note further, that there is an alternative explanation for benefit retrenchment in times of relatively low income in the manufacturing sector: Low income may lead to conflict over policy within trade unions, to a loss in membership and subsequently to a loss in political influence. Thus, even if trade union representatives are opposed to welfare retrenchment, they may not be able to prevent it (see Paper One for a more detailed discussion of the case of German trade unions).

are determined by other political and economic factors. Two factors that are frequently discussed in the political economy literatures on determinants of structural reforms are government partisanship and economic crises.

The effect of government partisanship on structural reforms has been studied widely, with contradictory outcomes. Most empirical studies find a negative relation between left-wing governments and reform or – more narrowly – welfare retrenchment propensity (Helbling et al. 2004, Alesina et al. 2006, Duval 2008, among others). Allan & Scruggs (2004, 507), for example, find 'reasonably strong partisan effects on welfare state retrenchment, even with controls for the macroeconomic context and other common factors generally held to impact the welfare state.' A second set of studies studies, however, finds a positive relation between left-wing governments and welfare retrenchment (Høj et al. 2006, Green-Pedersen 2007, among others). This counterintuitive relationship has been linked to an alleged erosion of the left-to-right political spectrum (Huber & Stephens 2001, Belloc & Nicita 2011). Others argue that left-wing governments can more credibly argue in favour of welfare cuts: 'Cuts imposed by the left may be viewed as trade-offs for increased spending in other policy areas, absolute essentials, strategic necessities, or, at a minimum, lower than those that would be experienced under parties of the right.' (Ross 2000, 165)

These inconclusive empirical results on the effect of government partisanship on welfare retrenchment may also be linked to the intermediating effect of corporatism. Most studies do not account for the effect of privileged interest representation in the political economies of many European countries.[6] As one of the exceptions, Pierson (2001a) argues that partisan control of government may be more important in pluralist than in corporatist political systems. He suggests that, in a pluralist setting, relatively low levels of welfare entitlements imply that 'pivotal voters are likely to possess weaker attachments to social provision, and to be more susceptible to alternative political appeals' (Pierson 2001a, 434). More generally, political power in pluralist systems is tied to success in electoral competition. To ensure their continued support, parties need to cater to their constituents. Broadly, left-wing governments are expected to pursue labour market policies that cater to their constituents among workers and employees. They will thus be more inclined to implement labour market regulation and more generous welfare systems, and be less inclined to pursue retrenchment than conservative governments.

[6] Notable exceptions are Allan & Scruggs (2004) and Høj et al. (2006).

Conversely, partisanship is expected to matter less in corporatist systems. In corporatism, privileged interest groups have significant political influence. This influence is broadly independent of the partisan composition of the government in office because the privileged interests commonly span political camps in corporatist countries (Traxler et al. 2001a, 302). Given that the allocation of political power is a zero-sum game, partisan interests have less room for manoeuvre with regard to the implementation of labour market policies. Corporatist interests acts as a constraint on partisan government (see Papers 1 and 2 for two more detailed discussions of how corporatism constrains partisan governments). Thus, the following hypothesis can be formulated:

Hypothesis 3 *If a government is more left-wing in pluralist countries, the likelihood of structural reforms that retrench unemployment benefits is significantly reduced. If a government is more left-wing in corporatist countries, however, the effect on the likelihood of reform is not significant.*

In addition to partisan politics, conventional wisdom holds that economic crises are one of the most important determinants of structural reform. Tommasi & Velasco (1996, 200) find '[t]hat economic crisis seems either to facilitate or outright cause economic reforms'. With different emphases and restrictions, quantitative empirical studies confirm the 'crisis hypothesis' (Drazen & Easterly 2001, Pitlik & Wirth 2003, Helbling et al. 2004, Høj et al. 2006, Alesina et al. 2006, Duval 2008, amng others). Generally, it is argued that crisis raises the social cost of the status quo institutional arrangements, which creates a degree of urgency in the political arena and thus weakens opposition to reform (Drazen 2000).

The 'crisis hypothesis' is likely to hold in a pluralist setting. More specifically, public policy on labour market and welfare institutions was – for the most part of the past three decades – dominated by a broad international consensus on the benefit of liberal market reform over the past decades. More specifically, a generous unemployment system was thought to distort labour markets in a growth-unfriendly way, contribute to long-term unemployment and thus present a heavy burden on public finances. Accordingly, economic crises increase pressure to reducing levels of unemployment benefits and increasing the degree of conditionality attached to benefit payments. They increase the likelihood of a 're-commodification' of the labour market in pluralist countries.

In a corporatist country, however, the political decision-making process is influenced by a narrower set of privileged interests. As argued above, these privileged interests are those of particular sectors of the economy, typically the exposed, manufacturing sector. In all European economies, the manufacturing sector is relatively small compared to the services sector. That is, GDP growth indicators – as a weighted measure of all sectors – reflect conditions in the services sector more than they do in the manufacturing sector. It is thus easy to imagine cases in which the economy as a whole is in crisis, while the income and profit situation in the narrower manufacturing sector remains stable. Privileged corporatist interests may thus oppose structural reforms, even if institutional change would seem to favour the economy as a whole in view of severe crisis (see Paper 2 for a more detailed exposition of this argument).

Hypothesis 4 *If a pluralist country is in economic crisis, the likelihood of subsequent structural reforms that retrench unemployment benefits significantly increases. If a corporatist country is in crisis, however, the effect on the likelihood of reform is not significant.*

4.3 Data

To test the above hypotheses, the paper precedes with an empirical analysis of the impact of political economy variables on the likelihood of structural unemployment benefit system reforms in Europe. More specifically, the analysis will focus on labour market reforms in the EU15 countries over 28 years, from 1980 to 2007.[7] To some degree, the selection of countries and time period is predetermined by the availability of data. The selection can, however, easily be rationalised on methodological grounds. First, the EU15 countries represent a relatively homogeneous group of countries in terms of basic economic and political characteristics, compared to the 34 OECD countries, for example, which comprise developing and transition countries. At the same time, they contain countries with corporatist and with pluralist politico-economic systems.

Second, the time period from 1980 to 2007 spans a time of broad consensus on market-oriented economic policy-making. It broadly covers the 'neoliberal era' or the era of the 'Washington Consensus', the emergence of which is commonly associated with the early 1980s and the end of which is arguably

[7] The EU15 is a common statistical reference group (see for example the OECD's Main Economic Indicators), which include the European Union member countries prior to the accession of ten Central and Eastern European countries in 2004. The EU15 comprise Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and United Kingdom.

marked by the global financial and economic crisis 2007–2009. In this period, market-oriented reform dominated the agenda of international organisations, such as the European Union, presumably putting pressure on all European governments to implement liberalising labour market policies. The time period selected thus excludes large swings in economic policy-making doctrine (for data sources and a data description, see Annex 4.B on page 192 and Table 4.4 on page 195).

An indicator for unemployment benefit system reform

In the absence of data measuring institutional change directly, empirical research has – *a priori*, quite plausibly – resorted to choosing changes in the prevalence of labour market institutions as a proxy for reform. More specifically, researchers use the year-on-year change of a measurement of the level of market regulation or benefit generosity as data for a regulatory change (Allan & Scruggs 2004, Helbling et al. 2004, Høj et al. 2006, Conway & Nicoletti 2006, Alesina et al. 2006, Duval 2008, Belloc & Nicita 2011, and others).

Measuring reform as changes in levels is, however, not without risks. Clasen & Siegel (2007a, 9) identify substantial 'dependent variable problems' in comparative welfare state research, pointing particularly to problems of comparability with measurements of welfare state generosity across countries and across time. Problems arise due to technical issues, such as discrepancies of statistical definitions and the quality of measurement across countries. They also arise due to conceptual issues of generalisation or oversimplification of reform measurements. The authors thus call on researchers to invest in the 'empirical infrastructure' of comparative research and 'move beyond a purely expenditure based and macroscopic perspective of the "welfare state" and engage in more detailed accounts of changes and policies at the level of individual social policy programmes.'

A new database on social reforms, developed under the auspices of the Institute for the Study of Labor (IZA) and Fondazione Rodolfo Debenedetti (fRDB), contributes to addressing the data problems highlighted by Clasen & Siegel (2007a). First, the database provides a direct record of regulatory change (Anelli et al. 2011).[8] More specifically, it provides a list and description

[8] The creation of the database is a collaborative exercise, involving national labour market experts from across Europe. Experts used existing qualitative data sources, such as the International Labour Organisation's Natlex collection of legislative changes or the European Commission's LABREF database. More often than not, information is obtained or verified from comparative analytical studies on specific policy areas in select countries as well as

of all regulatory changes to three important areas of labour market: employment protection legislation, the unemployment benefit system and the pension system. Currently, the database lists all reforms for the EU15 countries, excluding Luxembourg, from 1980 to 2007. The unit of analysis of the database is change to existing regulation in the form of 'unique formally approved documents' (Anelli et al. 2011, 4).[9] Reform packages, which address more than one of the three policy areas, are recorded several times accordingly. Planned reforms, reform proposals or failed reforms are not included.[10]

A second central feature of the database is a qualitative assessment of each observation of reform, both in terms of direction and scope. This assessment indicates in what way the reform has changed the welfare state, increasing or decreasing the degree of decommodification in the labour market. More specifically, the qualitative assessment indicates whether a reform has increased or decreased labour market flexibility, whether a reform has increased or decreased rewards from labour market participation. A positive (negative) sign indicates an increase (decrease) in flexibility, rewards and generosity in the three policy areas. Additionally, each reform measure is assessed to be either 'marginal' or 'structural'.[11] A structural reform must be a 'comprehensive reform, address-

governmental reports, institutional websites etc. The author of this PhD project was one of the country experts who put together and cross-checked the database.

[9] While structural reforms are typically defined as formally adopted changes to laws and regulation, many socio-economic institutions exist not on the grounds of formal legislation, but by convention. Examples are wage bargaining agreements, tripartite agreements on work hours, etc. A good reform indicator will have to also incorporate changes to these institutions. Accordingly, besides enacted national legislation, the database also records other public acts and collective agreements.

[10] The unavailability of data on failed reform is a fundamental problem of quantitative research on the determinants of reform. An observation of 'no reform' may be either due to opposition to the policy (a blocking veto) or due to the fact that there was no reform initiative. Given that there is no data available on failed reforms, there is no immediate methodological solution to the problem of 'non-decision' (Bachrach & Baratz 1962, 1963). However, the problem is less relevant for a research agenda attempting to explain instances of reform rather than instances of non-reform. First, to assess under which conditions reform happens, the dependent variable has to capture instances of successful reform. 'No reform attempt' and 'failed reform attempt' can simply be pooled together. Second, given that the nature of the data is biased towards non-reform (reform attempts are not included), the study is likely to produce type-II-errors (failure to rejecting the null-hypothesis that is in fact false) if any. Arguably, the study thus stacks the cards against itself. Third, Petring (2010) argues that using a probabilistic regression method – which does not infer a definite relationship between the dependent and independent variable, but rather suggests that the likelihood of reform is increased (reduced) in the presence (absence) of particular independent conditions – further reduces the problem.

[11] A legislative act often contains a bundle of measures, some of which increase, while others decrease market freedom. In these cases, the database lists all measures as separate reforms, attributing individual signs. At the same time, it also provides an overall sign to the legislative act.

rewards from labor market participation	ueb
(1) structural increase	1
(2) marginal reform or no reform	0
(3) structural decrease	-1

Table 4.1: Coding of the reform indicator `ueb`

ing the broader design of the existing system' (Anelli et al. 2011, 7). Note that structural reforms in the database are thus broadly congruent with the definition of structural reforms provided in the Introduction of this PhD Project, namely implemented 'government policies intended to fundamentally change [...] the institutional structure governing a policy sector'.

For the unemployment benefit system, the database provides an assessment of whether a reform increases or decreases benefit generosity and, with it, individual incentives to participate in the labour market. For example, a reform increases rewards from labour market participation if it reduces the amount or the duration of unemployment benefits, if it makes eligibility conditions for unemployment benefits stricter, or if it introduces employment-conditional incentives or activation schemes. Vice-versa, a reform decreases rewards from labour market participation if unemployment benefits are increased or if eligibility conditions are eased. Additionally, it provides an assessment of whether each individual reform is of a marginal or a structural nature. The introduction of a universal early retirement scheme, for example, would qualify as a 'structural reform', expanding the unemployment benefit system. However, the limitation of the eligibility criteria of the early retirement scheme would be rated a 'marginal reform', retrenching unemployment benefits.

In the following, this empirical analysis will focus on instances of structural reform.[12] Further, the database is coded into an annual format, producing a panel dataset of the 14 EU member states with a categorical indicator (`ueb`). For the reform of the unemployment benefit system, one can thus distinguish between three different states of the world: (1) a year with structural reforms increasing rewards from labour market participation, (2) a year with no structural reforms, (3) a year with structural reforms decreasing rewards from labour market participation (see Table 4.1 on page 157).

[12] Marginal reforms to socio-economic institutions can – over time – have a transformative impact on the institutional structure of a political economy (Streeck & Thelen 2005). A chain of marginal changes to an early retirement scheme, each tightening the eligibility criteria, may, for example, render the scheme meaningless over time. However, it is argued that mechanisms determining marginal reform may differ significantly from the mechanisms determining structural reforms (see Introduction to PhD project).

How well does `ueb` reflect labour market reform trajectories in Europe? For the case of Germany, for example, the indicator includes five instances of reform that structurally changed the unemployment benefit system. First, it captures a 1983 law, which – for the first time – links entitlement duration to the record of social security contributions (`ueb`=1). Second, the introduction of a general early retirement scheme in 1989 is listed (`ueb`=-1). Third, the database includes the massive expansion of active labour market policies after reunification in 1993 (`ueb`=-1). Fourth, it includes the labour market reforms of the Kohl government, which significantly tightened the eligibility criteria for unemployment benefits in 1996 and 1997 (each `ueb`=1). Fifth and finally, the first overhaul of the broader politico-economic institutions in post-war Germany with the so-called Agenda 2010 reforms of the Schröder government is reflected with the 'Hartz I Law' in 2002, the 'Hartz III Law' in 2003 and the 'Hartz IV Law' in 2004 (all `ueb`=1). Marginal reforms to the unemployment benefit system, such as the Job-AQTIV-Law of 2001, are not included. For the sample of unemployment benefit system reforms in Germany, the data broadly covers the reform instances also highlighted in other, qualitative studies of the reform trajectory in Germany since the 1980s (for example in Paper One of the PhD project).

Comparing the `ueb` indicator with level-changes in unemployment benefit expenditure, an indicator commonly used to measure reform in qualitative research, reveals substantial differences (see Figure 4.1 on page 159).[13] The correlation between `ueb` and changes of the level-change indicator is very weak (-0.14), but mildly significant ($p<0.05$). This result may be explained by a number of factors. Most importantly, the level-change indicator – like many other macro-quantitative indicators – measures changes in the wage replacements, but not other reforms of the unemployment benefit system, such as changes to the eligibility criteria. Changes in unemployment numbers and base effects (in GDP) are likely to be disturbing factors. These are likely to explain the largest part of the difference between the two indicators. Additionally, the level-change indicator records changes in replacement rates in the year they are implemented, but not in the – politically more relevant – year in which they were passed. Finally, the general quality problems of using level indicators to measure reform discussed above should be kept in mind: While `ueb` is a reform indicator that is based directly on 'a detailed accounts

[13] Level-change indicator is the year-on-year change in cash expenditure compensating for unemployment as a percentage of GDP (public and mandatory private), calculated from Armingeon et al. (2010).

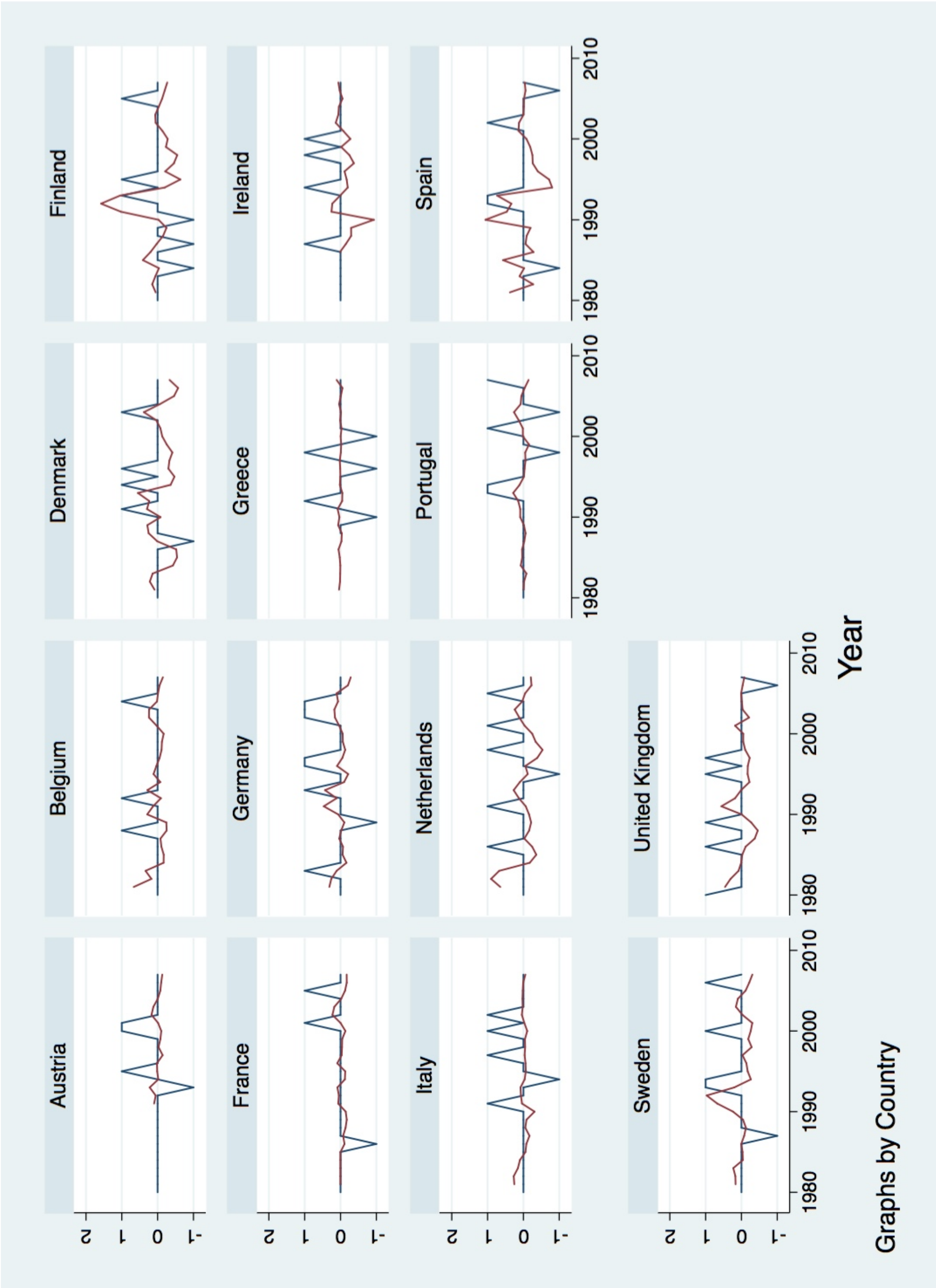


Figure 4.1: Comparing `ueb`, an indicator for reform (blue line), with the changes in unemployment benefit expenditure (red line)

of changes and policies at the level of individual social policy programmes' as demanded by Clasen & Siegel (2007a), the level-change indicator is based on a quantitative, socio-economic measurement, which is subject to technical and conceptual problems when compared over time and across countries.

An indicator for corporatism

Reflecting the relatively heterogeneous field of corporatism research by political economists and political theorists, among others, qualitative indicators of corporatism are aplenty.[14] However, many of these indicators present dangerous pitfalls. Most recent quantitative indicators of corporatism were developed in the political economy rather than in the democracy theory strand of the literature. Accordingly, these indicators stress union density, wage bargaining coverage and working days lost to strike. Høj et al. (2006, 73), for example, uses a joint variable of union density, strike activity and a summary indicator of the degree of wage centralisation, weighted by the prevalence of automatic extensions of wage contracts. These indicators have a strong bias towards wage setting arrangements (Christiansen et al. 2009, 26). A high degree of wage coordination by itself, however, does not imply that important politico-economic decisions are generally reached in consultation with employer organisations and trade unions.

Fewer measures of corporatism stem from the democracy theory strand of the literature and focus on the participation of employer organisations and trade unions in policy-making.[15] Visser (2009, 13) provides an indicator for 'involvement of unions and employers in government decisions on social and economic policy'. This indicator captures more of the political dimension of corporatism. However, it is also inappropriate as a proxy for corporatism because of its bias towards formal involvement of unions and employers in the political decision-making process. For example, the indicator captures multiple attempts of the Italian and French governments to to reach particular policy objectives by means of concertation with the social partners. It neglects, however, that one of the distinct features of corporatism is the deep and involuntary integration of organised interests in the policy-making process – beyond formal and voluntary initiatives of an incumbent government.

This study uses a dichotomised version (`corp`) of the indicator for politico-

[14] Kenworthy (2003), for example, provides a survey and assessment of 42 such indicators.

[15] Kenworthy (2003) only identifies two early, time-invariant quantitative indicators of corporatism that address interest group participation in policy-making.

economic 'integration', provided by Siaroff (1999, 177) and defined as the 'the co-ordinated, co-operative, and systematic management of the national economy by the state, centralised unions, and employers'. This definition clearly goes beyond measurements of coordination between trade unions and employer organisations, or sporadic policy coordination with the government. Rather, it captures the close interlock of selected societal interests and political institutions. It is a widely used (Allan & Scruggs 2004, Iversen 2005, Armingeon et al. 2010) and acclaimed (Molina & Rhodes 2002, 321). Eight variables enter the indicator, which measure interest group organisation and social partnership (annual average level of strike volumes, nature and goals of trade unions, legal and state support for unions and union power), industry-level co-ordination (nature of economic ties and outlook of firms, extent of co-determination in the workplace) as well as national policy-making patterns (the nature of national industrial adjustment and wage setting, the extent of exchange in industrial relations and national policy-making, and the general nature of public-private interaction). A composite indicator for the level of integration is subsequently calculated for 24 industrialised countries, where "1" indicates a fully pluralist and "5" indicates a fully corporatist country.

The dichotomised version of the 'integration' indicator (`corp`) devides the EU15 (*ex* Luxembourg) into a corporatist and a pluralist group of countries and provides a relatively robust dummy variable for corporatism. First, a strong (0.95) and highly significant ($p<0.001$) correlation between `corp` and the continuous Siaroff (1999) indicator indicates that not much information is lost on account of the simplification. Seven of the 14 countries included in the dataset on structural reforms display a high or very high integration score; namely Sweden, Finland, Denmark, Austria, Germany, the Netherlands and Belgium. Scores for the United Kingdom, Ireland, Portugal, Spain, France and Italy are low or very low.[16] Indeed, Siaroff (1999, 176) finds that 'industrial democracies have been neatly dichotomised between integrated ("corporatist") and non-integrated ("pluralist") economies'. Second, every country in the corporatist group scores above average in almost all other available corporatism indicators. At the same time, countries in the pluralist group almost always score score below the average.[17] Third and last (but maybe not least), the two groups of countries are broadly in line with a conventional classification of

[16] While the indicator provided by Siaroff is time-variant, scores for the countries in the sample do not change significantly. This is also true if the time series is extended through the 2000s.

[17] Indicators were taken from Leertouwer & de Haan (2002), Kenworthy (2003).

	Pluralism	Corporatism	Total
expansion	10	8	18
no reform	154	159	313
retrenchment	24	29	53
Total	188	196	384

Table 4.2: Frequency of `ueb` across systems

European countries into more corporatist and more pluralist politico-economic systems.

The dummy indicator for corporatism (`corp`) allows for a group comparison of observations with and without integration of organised interests in the policy-making process. This makes the interpretation of results considerable easier than a time-variant indicator. Comparing, for example, the frequency of reform years across politico-economic regimes in Europe produces the first substantive empirical finding: In line with the new thinking about structural reforms in continental European countries, labour market reforms have a similar prevalence in corporatist and pluralist countries. In both regimes, governments implemented structural reforms to the unemployment benefit system with a similar frequency (see Table 4.2 on page 162).

Measurement of employer organisation and trade union utility

Finally, the paper turns to the measurement of employer organisation and trade union utility. Section 2 established that trade unions and employer organisations are expected to pursue the interests of their constituents, workers and firms in the manufacturing sector.

First, an indicator of employer organisation utility (`emplutil`) is reasonably assumed to be a function of the profitability of manufacturing firms. Real annual gross operating profits by sector can be calculated from the data provided by the OECD's 'STAN Structural Analysis Database'. To allow for better comparability across countries and years, this study uses deviations of real manufacturing profits from the long-term, linear trend. In other words, it is assumed that the utility of firms is relatively high in years with profits above trend and relatively low in years with profits below trend (for more details on the calculation of employer utility please refer to Annex 4.B on page 192).

A graphical analysis of the indicator shows that deviations from trend can be quite significant and typically persist over a number of years (see Figure 4.2

on page 164). For example, in the case of Germany manufacturing profits were above trend in the second half of the 1980s, fell below trend in the early 1990s and only rose above trend again in the mid-2000s. According to Hypothesis 1, we would expect welfare retrenchment in the 1990s and early 2000s, which is what the reform indicator (`ueb`) shows. In the case of Germany, the reform data matches the prediction of `emplutil` well.

Turning now to the measurement of trade union utility (`unionutil`), Section 2 established that trade unions represent the interests of their constituents, blue-collar workers in the manufacturing sectors. Broadly following Layard & Nickell (1990) and Mares (2006), the indicator of trade union utility accounts for income of both of the employed and the unemployed manufacturing worker.[18] Accordingly, the paper calculates trade union utility as the sum of real take-home income of a representative, employed manufacturing worker and the real wage replacement payments to a representative, unemployed manufacturing worker, weighted with the probability of employment and unemployment respectively (for more details on the calculation of trade union utility please refer to Annex 4.B on page 192).[19] Again, the deviation of real take-home income of a representative manufacturing worker from the long-term, linear trend will be used.

Note, however, that the wage component outweighs the insurance component in the utility function of the trade unions. The probability of unemployment in most advanced European countries remains relatively low, with unemployment rates over 10 percent for only a limited number of observation. This implies that take-home income of a manufacturing worker is typically weighted with 90 percent and more.[20] Note that Saint-Paul (1996) similarly finds that while the wage effect of labour market institutions is indeed important for trade union policy, there is no evidence that the insurance component matters. In other words, the utility function of trade unions is – first and

[18] Note that including the income of unemployed manufacturing workers in the utility function of the trade union can be interpreted in two ways: The trade union takes account of the probability of unemployment (and the respective unemployment income) of an employed worker (argument presented in Section 2). Alternatively, trade unions can the thought to genuinely care for the utility of the unemployed fraction of the manufacturing workforce.

[19] Obtaining data for take-home income of a manufacturing worker is not trivial. It requires calculating the average income, the progressive income tax an national and in many cases at regional level as well as the social security contributions (which are commonly also calculated on a progressive scale) for a representative worker for each of the 420 observations.

[20] It is thus assumed that trade unions are risk neutral regarding probability of unemployment of their constituents. Changing the weighting towards a more risk-averse trade union utility function – for example, utility function that weighs the wage component and insurance component with 50 percent each – does not change the results.

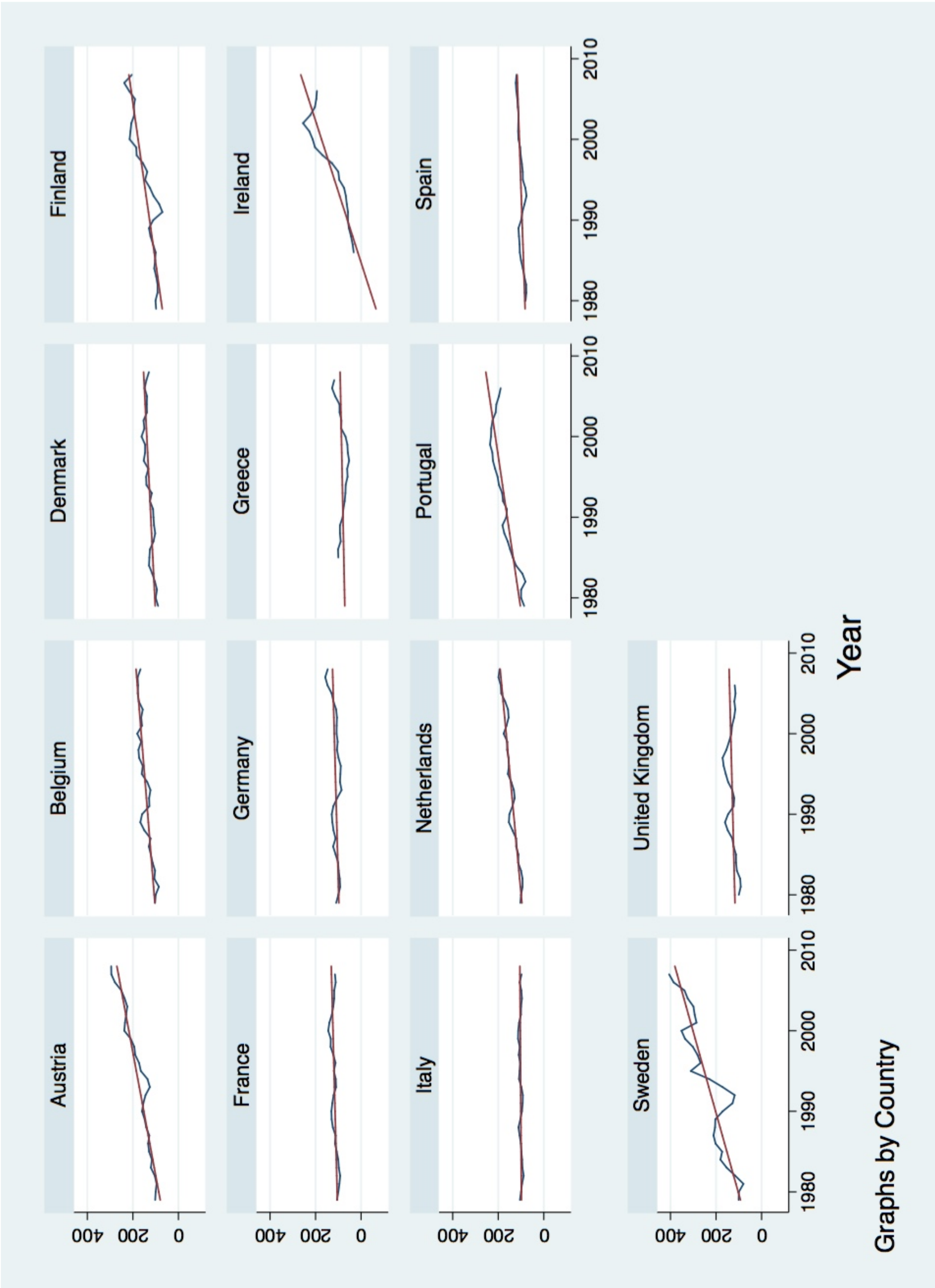


Figure 4.2: Index of the deviation from trend of real profits in the manufacturing sector, `emplutil`. Base year is 1980, except in the case of Greece and Ireland, where time series start in 1985 and 1986 respectively.

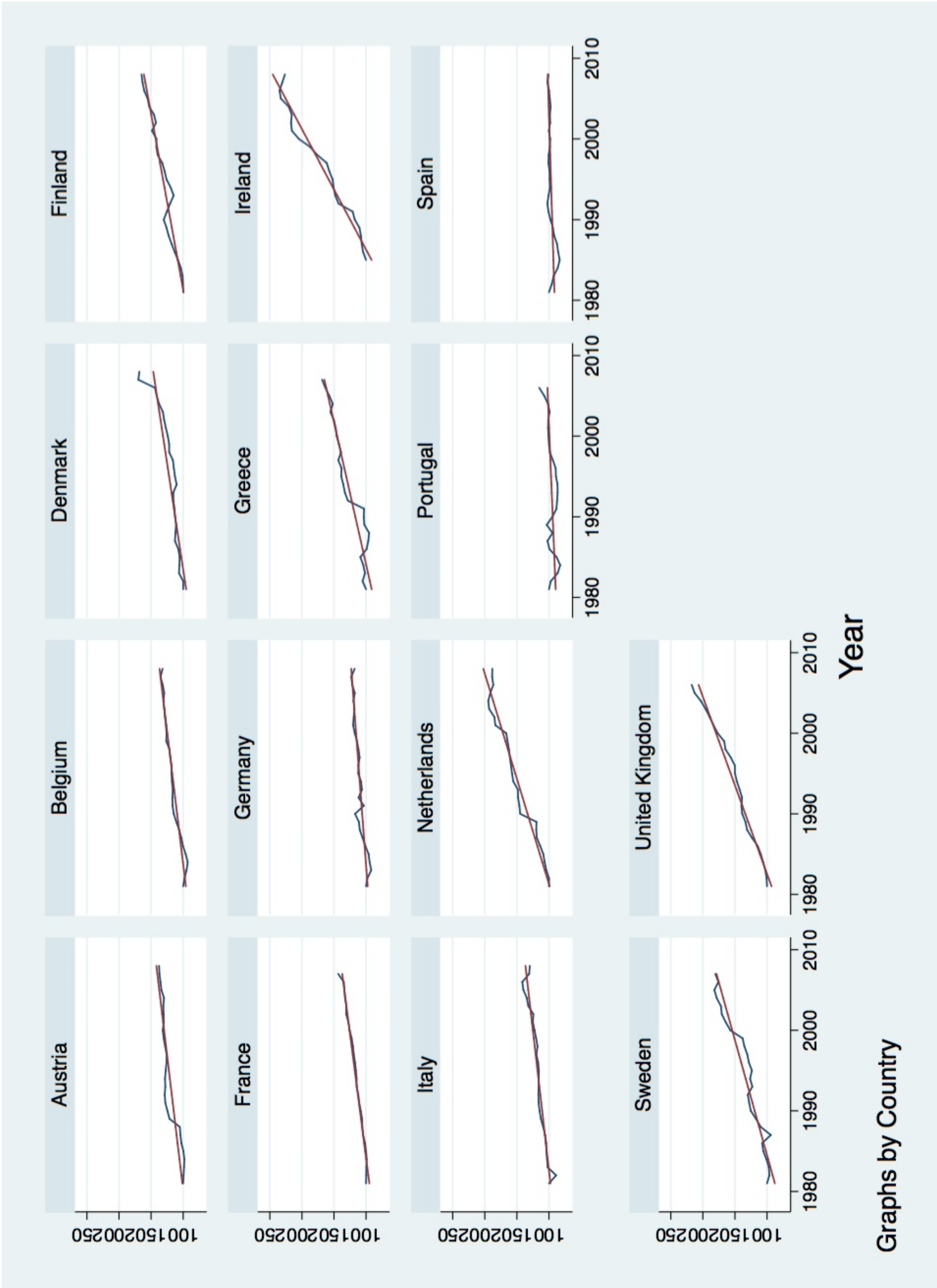


Figure 4.3: Index of the deviation from trend of trade union utility, `unionutil`. Base year is 1981.

foremost – a function of the real take-home income of employed workers.

The `unionutil` indicator has the advantage of capturing the income effect of the trade unions utility function very well; changes in gross paid wages, changes in income taxes as well as changes in the price levels (see Figure 4.3 on page 165). First, the indicator reflects major tax reforms. For example, the time-series for Austria shows that a 1988 tax reform 'brought a significant drop in average and marginal tax rates for all income groups' (Schratzenstaller & Wagener 2009, 310). Similarly, both of the two major personal income tax reforms in the Netherlands in 1990 and 2001 (Caminada & Goudswaard 2001) are well reflected in the data. Second, the indicator also captures changes in social security contributions. For example, the gradual (re-)introduction of employee social security contributions in Sweden and in Finland in the mid-1990s (Timonen 2003) show up as lower income growth levels in both countries. Third, high nominal wage increases, particularly in Greece and Portugal, but also in Italy and Spain, were to translated into high real wage growth rates. Countries with high CPI inflation saw their real income growth depressed.

4.4 Empirical specification

To test the hypotheses put forward in Section 2, the following baseline model will be estimated, using the data discussed in the previous section:

$$
\begin{aligned}
logit[Pr(\texttt{ueb} \leq j)] \quad = \quad & \alpha_j - \beta_1 \texttt{corp}_{i,t} \\
& -\beta_2 \texttt{emplutil}_{i,t-1} \\
& -\beta_3 \texttt{unionutil}_{i,t-1} \\
& -\beta_4 \texttt{partisanship}_{i,t} \\
& -\beta_5 \texttt{growthcrisis}_{i,t-1} \\
& -\beta_6, \texttt{initialueb}_{i,t-2} \\
& -\beta_7 \texttt{corp}_{i,t} \times \texttt{emplutil}_{i,t-1} \\
& -\beta_8 \texttt{corp}_{i,t} \times \texttt{unionutil}_{i,t-1} \\
& -\beta_9 \texttt{corp}_{i,t} \times \texttt{partisanship}_{i,t} \\
& -\beta_{10} \texttt{corp}_{i,t} \times \texttt{growthcrisis}_{i,t-1} \\
& -\beta_{11} \texttt{corp}_{i,t} \times \texttt{initialueb}_{i,t-2}
\end{aligned}
$$

Note, first, that the dependent variable is ordinal, in that the values of `ueb` can be ranked from category -1 (indicating a structural regulatory reform) to 1 (indicating a structural deregulatory reform). An appropriate model to analyse this data is the ordinal logit model. In technical terms, this is specified to provide the probability (in logit or log-odds) of `ueb` taking a value of j or less, where $j \in [-1, 0]$ (Agresti 2010). More informally, the regression output (denoted in log-odds) can be understood as the probability of being in one reform category rather in the adjacent, higher reform category (for a detailed discussion of the econometric approach, see Annex 4.A on page 189).[21]

Second, the model includes the main explanatory variables: These are the trend-deviation of utility of employer organisations (`emplutil`), the trend-deviation of utility of trade unions (`unionutil`), and a dummy variable for years in which growth negatively deviated from its (country specific) average by more than one standard deviation (`growthcrisis`). These three variables are lagged by one year to exclude the possibility of endogeneity of reform policies. The fourth variable is the percentage of cabinet posts held by social democratic and other left parties, weighted by days (`partisanship`).

Third, to correct first-order autoregressive errors in cross-country empirical studies, including the lagged dependent variable as a covariate is commonly suggested (Beck & Katz 1995). Initial regulatory conditions may have an impact on the reform propensity. Relatively high levels of benefits relative to other economies may increase pressures to reform, for example. To control for this effect, the model includes a measure of the generosity of the unemployment benefit system (`initialueb`), lagged by two year to account for endogeneity and the biannual character of the data.

Fourth, to allow for a comparison between countries i and years t with and without systems of corporatist interest representation, observations need to be attributed to a group. A commonly used method is to produce regression estimates for the data of each group separately, which has several disadvantages, however. To include both groups in the same model, a dummy variable and interactions are used, following Long (2009). More specifically, each of the explanatory variables is interacted with the corporatism dummy (`corp`). The regression thus produces estimates for coefficients in the group with plu-

[21] Please take note of some further specifics of this ordinal logit or 'proportional odds' model: There is no $j = 1$, given that the probability of `ueb` taking the value of '1 or less' is equal to one. Rather than an intercept, the model provides 'cuts' between each of the ordinal categories, denoted here as α_j. The signs of coefficients for the exogenous variables have negative rather than the usual positive sign. This is, so that positive coefficients indicate that higher values of `ueb` are more likely, while negative coefficients indicate that lower values of `ueb` are more likely (Norušis 2011).

ralist interest representation, the so-called 'main effects' (where `corp` is equal to zero). The regression also produces estimates for the so-called 'interaction effects', which provide an indication on the difference of the coefficients when moving from the group with pluralist interest representation to the group with corporatist interest representation (where `corp` is equal to one). A linear combination of the 'main effects' and 'interaction effects' estimators allows for a calculation of overall coefficients also for the corporatist group of countries.

Finally, in a first and second extension of the baseline model, several covariates are included. These include, alternatively, the political and economic institutions and conditions that are commonly subject to investigation in empirical studies on the determinants of structural reforms. As covariates on political institutions, the study includes a measure of the number of veto points in a political system (`vetopoints`) – for example a chamber of the legislature held by the opposition, parties in the government coalition etc. – a dummy variable for years preceding a national parliamentary election (`electyear`) and a measure of the strength of trade unions (`unionpower`).

As covariates on economic conditions, the study includes the output gap (`outputgap`), a measure of the difference between actual and potential GDP, the annual unemployment rate (`unemployment`) and the deficit-to-GDP-ratio (`deficit`). Again these covariates are lagged by one year to account for potential endogeneity issues, given that substantially higher or lower unemployment benefits may well impact growth, employment and public finances. Economic indicators are further calculated as deviations from trend to account for country-specific effects.

4.5 Discussion of results

The following section provides and discusses estimation results. The discussion is, however, complicated by the fact that – beyond sign and significance level of coefficients – the log odds estimation results of an ordinal logit regression model are difficult to interpret. The paper thus first only provides a short discussion of sign and significance levels of the estimates as well as the two extensions of the model. In a second step, the section then presents graphically and discusses the marginal effects of corporatism on reform determinants in more detail.

ueb	Model 1		Model 2		Model 3	
	corp=0	corp=1	corp=0	corp=1	corp=0	corp=1
emplutil	·	– – –	·	– – –	·	– –
unionutil	·	– –	·	– –	·	– –
partisanship	– –	·	–	+	– – –	·
growthcrisis	+ +	·	+ +	·	+	·
vetopoints			– – –	·		
electyear			– –	·		
unionpower			– – –	– – –		
outputgap					– –	·
unemployment					+ + +	– –
deficit					·	– –

Table 4.3: Main results of regression estimates for ueb. Note that · denotes that there is no significant effect, + (–) denotes a positive (negative) effect at p<0.1, ++ (– –) denotes a positive (negative) effect at p<0.05, and +++ (– – –) denotes a positive (negative) effect at p<0.01.

Signs, significance levels and robustness

Table 4.3 on page 169 provides the results of the regression exercise. For simplicity, the table only indicates the sign and significance levels of the coefficients. The full regression table can in found in the Annex (see Table 4.5 on page 196).

The table is to be interpreted as follows: A positive sign indicates that a one unit increase (decrease) of the explanatory variable will increase (decrease) the log odds of being in a higher reform category rather than a lower category by the value of the coefficient, given that all the other variables in the model are held constant. In other words, starting from a baseline with no reform (ueb=0), a significant positive coefficient indicates that the probability of a structural reform expanding unemployment benefits decreases and the probability of benefit retrenchment increases with an increase in the explanatory variable (holding other variables constant). A significant negative coefficient indicates that when the explanatory variable increases, the probability of a benefit retrenching structural reform decreases, while the probability of benefit expansion increases (holding other variables constant).

Model 1 includes only the main explanatory variables.[22] It provides some first evidence in favour of the hypotheses presented in Section 2: Privileged interest representation has a significant impact on reform trajectories in cor-

[22] All models also include the lagged variable on the wage replacement rate initialueb. This is positive and mostly significant, indicating that high levels of ueb increase the likelihood of welfare retrenchment and reduce the likelihood of further expansion.

poratism, but no impact in pluralism. More specifically, the coefficients of `unionutil` and `emplutil` are significant in the corporatist group of observations (where `corp`=1) and insignificant in the pluralist group of observations (where `corp`=0). The negative signs of the coefficients of `emplutil` and `unionutil` indicate that – all other things being equal – a reduction in employer and trade union utility increases the likelihood of unemployment benefit retrenchment in a corporatist setting. There is no evidence for such an effect in a pluralist setting.

At the same time, partisan politics and economic crises matter for reform trajectories in pluralism, but not in corporatism. In pluralist countries, the coefficient of `partisanship` is negative and significant: More left-leaning governments are less likely to retrench unemployment benefits. The coefficient of `growthcrisis` is positive and significant: The 'crises hypothesis' seems to hold in the pluralist group of countries and growth crises increase the probability of unemployment benefit retrenchment. Both `partisanship` and `growthcrisis` do not seem to have a impact on reform trajectories in corporatist countries, given that their coefficients are not significant.

These results appear broadly robust against extensions of the model. The addition of political covariates (Model 2) or economic covariates (Model 3) does not change the signs and does not fully erode the significance of the main explanatory variables.[23] Further, the suggested post-estimation diagnostics for ordinal logit models show no significant problems.[24] Other statistical regression models provide similar results for the core explanatory variables.[25]

It may be worth noting that Model 2 provides some further insights on

[23] A positive and significant estimate for the coefficient `partisanship` in Model 2 indicates that more left-leaning governments are more likely to retrench unemployment benefits in this model specification. This result may capture the fact that a number of 'new labour' governments introduced benefit retrenching reforms in corporatist European countries.

[24] First, an important assumption underlying ordinal logistic regression is that the relationship between each pair of outcome groups is the same. In other words, 'the coefficients that describe the relationship between the lowest versus all higher categories of the response variable are the same as those that describe the relationship between the next lowest category and all higher categories, etc.' ('Stata Data Analysis Examples: Ordinal Logistic Regression', UCLA Academic Technology Services, Statistical Consulting Group, `http://www.ats.ucla.edu/stat/stata/dae/ologit.htm`, retrieved 12.01.2012 12:23) The Brant Test for this proportional odds assumption shows up as non-significant. Second, the model is tested for multicollinearity, also showing no significant violation of the assumption of independent covariates.

[25] Please note that running separate regressions for observations with corp=0 and corp=1 renders almost the same coefficients and very similar significance levels as running the model with interaction effects. Also, broadly similar results – in terms of coefficient signs and significance levels – are obtained when estimating this model with a 'Linear Probability Model' (with robust standard errors) or an 'Ordinal Generalized Linear Model'.

the effect of political factors on structural reform trajectories across corporatist and pluralist countries. First, the negative and significant coefficient of `vetopoints` in pluralist countries indicates that unemployment benefit retrenchment is less likely and benefit expansion is more likely in the presence of a higher number of veto points in the political system.[26] Second, the negative and significant coefficient of `electionyear` in pluralist countries indicates that unemployment benefit retrenchment is less likely and benefit expansion is more likely in times of electoral pressure. This may reflect government electioneering, and the attempt to increase chances of re-election. There is no evidence that these two political factors – veto points and electoral pressure – significantly determine reform trajectories in pluralist countries. Third, the estimation of the coefficient `unionpower` indicates that higher union density generally reduces the probability of unemployment retrenchment.[27] Note that the inclusion of `unionpower` does not diminish the significance of the main explanatory variable `unionutil`. Assuming that union density is a reasonable proxy for union power, this result provides some indication that a drop in utility of representative manufacturing workers does not (or not only) reduce union political influence, thus dissolving the trade union's veto power over welfare retrenchment. Rather a drop in the take-home income of representative manufacturing workers may indeed prompt trade unions to push for a reform of the unemployment benefit system.

Model 3 provides some further insights on the effect of economic factors on structural reform trajectories in corporatist and pluralist countries. First, the negative and significant coefficient for `outputgap` indicates that a drop of GDP, relative to potential, increases the probability of welfare retrenching structural reforms in pluralist countries, but not in corporatist countries. This provides some further evidence that the general economic situation matters for reform trajectories in pluralist, but not in corporatist countries. Importantly, `outputgap` does not diminish the significance of the variable for employer interest in corporatist countries, showing that `emplutil` is not merely an alternative measure of economic activity. Second, the positive and significant coefficient for `unemployment` for pluralist countries indicates that above trend unemployment increases the probability of unemployment benefit retrenchment and reduces the probability of its expansion. It is easy to see why

[26] This result could be interpreted to point towards the 'new politics of the welfare state' (Pierson 2001a), arguing that welfare retrenchment is more likely to be blocked by veto players than the expansion of the welfare state.

[27] The effect is smaller in corporatist countries, see full regression table on page 196.

pressure may arise to reduce the generosity of unemployment benefits if unemployment is above trend, given that lower benefits increase work incentives and reduce the burden of the benefit system on public finances. Somewhat surprisingly, the coefficient for `unemployment` is negative and significant in corporatist countries. Third and also surprisingly, above trend deficit-to-GDP ratios (`deficit`) do not seem to affect reform policies in pluralism, but do have an effect in corporatist countries.

Marginal effects

To allow for a more in-depth analysis of these results beyond mere sign and significance levels, a survey of the 'predictive margins' is commonly recommended (Long 2009, Williams 2012).[28] The paper provides an analysis of predicted probabilities of structural reforms retrenching unemployment benefits to further verify the evidence for the hypothesis presented in Section 2.

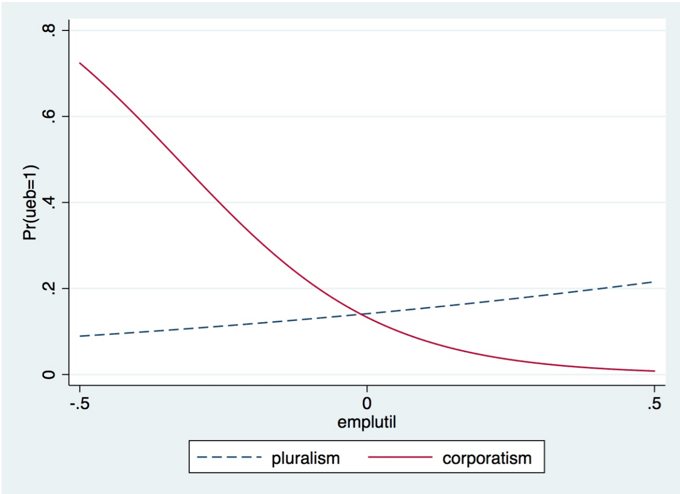
More specifically, Figures 4.4(a) to 4.7(a) show predicted probabilities of benefit retrenchment for the full range of values of the four explanatory variables in Model 1.[29] Blue lines indicate probabilities in pluralist countries and red lines indicate probabilities in corporatist countries. Figures 4.4(b) to 4.7(b) show the difference between the predicted probabilities between corporatist and pluralist countries. In other words, they provide a measure of how the effect of an explanatory variable differs between pluralism and corporatism. The confidence interval gives an indication for which range of values these differences are significant.[30]

Starting with **employer utility**, Figures 4.4 on page 173 provides a graphical illustration of predicted probabilities of unemployment benefit retrenchment (`ueb`=1) for the full range of values of `emplutil`, keeping all other variables constant. First, the red line in Figure 4.4(a) shows that, in corporatist

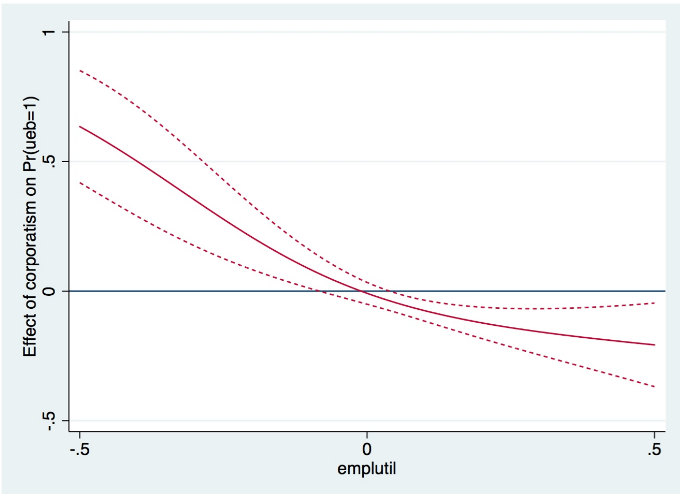
[28] In more technical terms, the log odds results of the regression estimation can be expressed in probabilities for the materialisation of `ueb` = -1, 0 or 1 by means of a nonlinear transformation. This implies, however, that the interactions between `corp` and the covariates are no longer a simple linear function of the predictors. That is, predicted probabilities for a particular covariate depend also on the value of all other covariates. Note that the graphical analysis provides the population-averaged marginal effect. That is, it allows 'comparing two hypothetical populations [...] that have the exact same values on the other independent variables in the model.' (Williams 2012, 326)

[29] Figures (a) provide the average predicted probability (y-axis) of a structural reform for a given value of the explanatory variable (x-axis).

[30] For values of the explanatory variable for which the confidence interval does not include the zero baseline, the difference in the predicted probability is significant at the 90 percent level.



(a) Predicted probabilities for unemployment benefit retrenchment for the range of values of `emplutil`



(b) Difference in probabilities between pluralism and corporatism for unemployment benefit retrenchment

Figure 4.4: Predictive margins of `ueb` for values in `emplutil` across corporatist and non-corporatist countries. Dashed lines indicate non-significant coefficients. Dotted lines indicate 90% confidence interval.

countries, predicted probabilities for unemployment benefit retrenchment remain relatively constant for above-trend manufacturing profits (between zero and 13 percent where `emplutil` is larger than zero). However, when `emplutil` falls below zero, the predicted probability of reform increases significantly. For extremely low values of `emplutil`, the predicted probability exceeds 50 percent. This is in line with expectations: in 'good times' employers are more likely to accept unemployment benefits, while they will urge retrenchment in 'bad times'. At the same time, the blue, dashed line shows that there is no strongly discernible effect of `emplutil` on predicted probabilities in pluralist countries. That is, predicted probabilities remain almost constant around the unconditional probability of about 15 percent for different values of `emplutil`.[31]

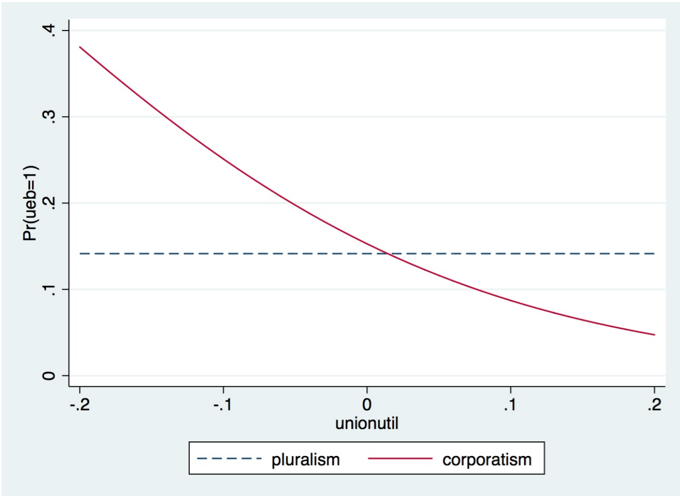
Second, Figure 4.4(b) confirms that the perceived difference in the effect of `emplutil` on predicted probabilities between corporatist and pluralist countries – the difference between the red and the blue line in Figure (a) – are indeed statistically significant. This is true across a relatively wide range of values of `emplutil`. Most importantly, differences are significant for manufacturing profits that are around five percentage points or more below trend.[32]

Overall, the graphical analysis further strengthens the evidence in favour of Hypothesis 1: In corporatist countries, the retrenchment of unemployment benefits is more likely when manufacturing profits are below trend than when manufacturing profits are above trend. In pluralist countries, manufacturing profits have no significant impact on the reform of the unemployment benefit system.

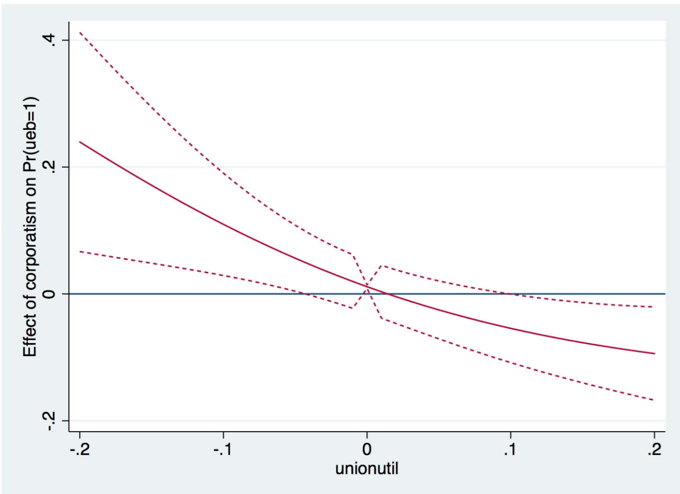
In turn, Figures 4.5 on page 175 illustrates how the probability of structural reforms changes for the different values of **trade union utility** in Model 1. First, the red line in Figure 4.5(a) shows that in corporatist countries a decrease in `unionutil` increases the probability of unemployment benefit retrenchment. Recall that in the utility function of the trade unions is dominated by the take-home income of employed manufacturing workers. The graphical analysis appears to confirm expectations: In times of below-trend manufacturing income, trade unions are willing to reduce the generosity of unemployment

[31] The unconditional probability is easily calculated from the frequency table 4.2 on page 162.

[32] Predicted probabilities are also significantly lower in corporatism than in pluralism for above-trend profits. Unsurprisingly, there is no significant difference in the effect of `emplutil` on structural reform probability if manufacturing profit growth is close to its trend.



(a) Predicted probabilities for unemployment benefit retrenchment for the range of values of `unionutil`



(b) Difference in probabilities between pluralism and corporatism for unemployment benefit retrenchment

Figure 4.5: Predictive margins of `ueb` for values of `unionutil` across corporatist and non-corporatist countries. Dashed lines indicate non-significant coefficients. Dotted lines indicate 90% confidence interval.

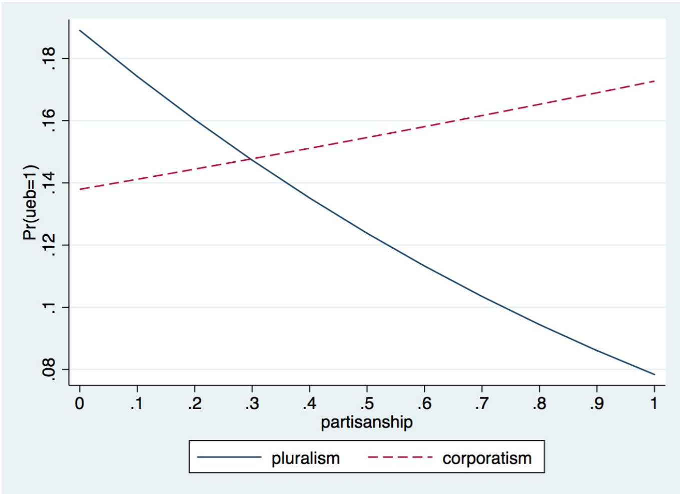
benefits to reduce the negative effect of taxes and social security contributions on their constituents' income. Starting from an unconditional probability for reform of about 15 percent in corporatist countries, the predicted probability for extremely low values of `unionutil` rises above 30 percent. For positive values of `unionutil`, predicted probabilities for retrenchment fall below the unconditional probability of benefit retrenchment. This indicates that manufacturing income above trend effectively reduces the probability of benefit retrenchment. In good times trade unions are not willing to agree to retrenchment to ensure income insurance of their constituents. At the same time, the dashed, blue line shows that in pluralist countries predicted probabilities for unemployment retrenchment do not change at all with `unionutil`.

Second, Figure 4.5(b) confirms that differences in the effect of `unionutil` on structural reforms are indeed significant between corporatist and pluralist countries. At a time when income growth in manufacturing is more than about five percentage points below trend, the effect of `unionutil` on reform probability in a corporatist country is significantly different from that in a pluralist country.

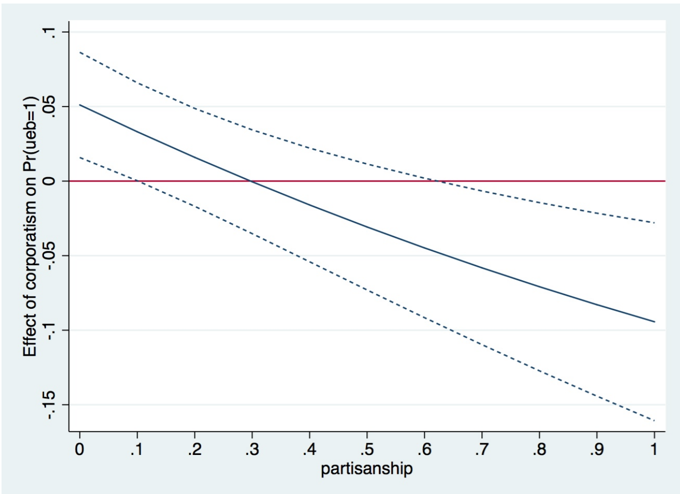
Together, Figures 4.5(a) and 4.5(b) confirm Hypothesis 2: In corporatist countries, the retrenchment of unemployment benefits is more likely when take-home income in the manufacturing sector is below trend than when manufacturing income is above trend. In pluralist countries, manufacturing income has no significant impact on the reform of the unemployment benefit system.

Turning to the effect of political and economic factors on reform probabilities, Figures 4.6 on page 177 shows how predicted probabilities of reform change for different **partisan compositions of the government**. First, the blue line for pluralist countries in Figure 4.6(a) shows an almost linear, downward-sloping relationship between the predicted probability of benefit retrenchment and `partisanship`. As expected, more cabinet seats held by left-wing parties reduces the probability of unemployment benefit retrenchment.[33] The effect is relatively small, however, changing predicted probabilities by only about 10 percent from an all-conservative to an all-left-wing cabinet. The red, dashed line for corporatist countries seems to imply that this effect is almost the opposite in corporatist countries, raising predicted probabilities from about 14 percent in an all-conservative to around 17 percent in an all-left-wing cabinet.

[33] In fact, for a cabinet composed of about 50% left-wing officials, the predicted probability drops below the unconditional probability of benefit retrenchment in corporatist countries of about 15%.



(a) Predicted probabilities for unemployment benefit retrenchment for the range of values of `partisanship`



(b) Difference in probabilities between pluralism and corporatism for unemployment benefit retrenchment

Figure 4.6: Predictive margins of `ueb` for values of `partisanship` across corporatist and non-corporatist countries. Dashed lines indicate non-significant coefficients. Dotted lines indicate 90% confidence interval.

This effect is, however, not significant in a statistical sense.

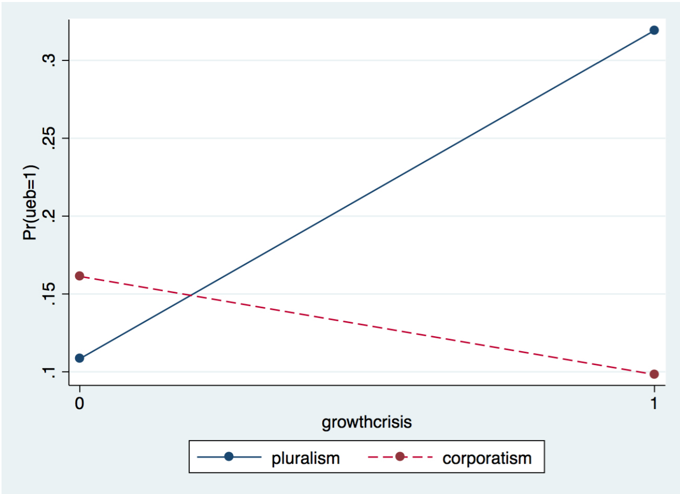
Figure 4.6(b) reveals some important limitation to the results. It shows that the negative effect of left-wing governments on the propensity to retrench benefits in pluralism is significantly different from the effect of left-wing governments in corporatist countries only for cabinets composed of more than approximately 65 percent left-wing officials.

Overall, however, evidence remains for Hypothesis 3: In pluralist countries, the retrenchment of unemployment benefits is less likely under a left-wing government than under a conservative government. In corporatist countries, government partisanship has no significant impact on the reform of the unemployment benefit system.

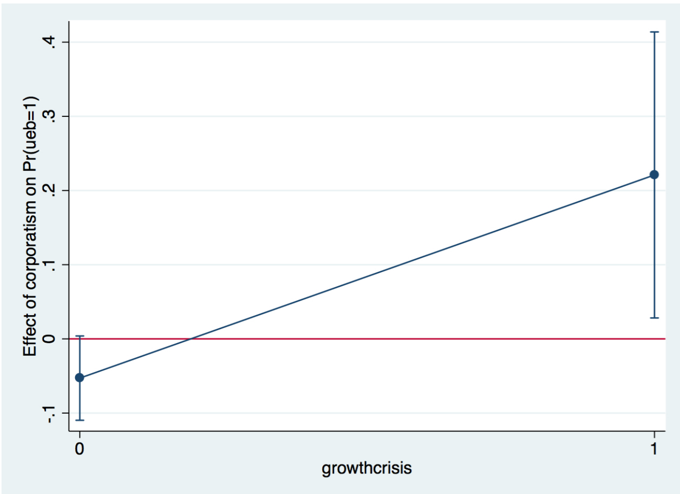
Finally, Figures 4.7 on page 179 illustrates how the predicted probability for structural reforms changes in the presence of a **GDP growth crisis**. First, the Figure 4.7(a) shows that in a normal economic environment predicted probabilities are both close to their unconditional probabilities of about 13 percent in pluralist and about 15 percent in corporatist countries. In average pluralist countries, a crisis increases the predicted probability of unemployment benefit retrenchment quite dramatically by almost 20 percentage points (blue line). Again, the effect of `growthcrisis` on benefit retrenchment is much weaker in the corporatist setting and is not significant in a statistical sense (red dotted line).

Figure 4.7(b) shows that these differences in the effect of `growthcrisis` on `ueb` between pluralist and corporatist countries are significant. There is no significant difference in the predicted probability in an environment without crisis, when predicted probabilities reflect unconditional probabilities of benefit retrenchment in pluralist and corporatist countries. Following a crisis, however, pluralist countries tend to implement more unemployment benefit retrenchment.

This confirms evidence in favour of Hypothesis 4: In pluralist countries, the retrenchment of unemployment benefits is more likely following a growth crisis than following a year without a crisis. In corporatist countries, growth crisis have no significant impact on the reform of the unemployment benefit system.



(a) Predicted probabilities for unemployment benefit retrenchment for values of `growthcrisis`



(b) Difference in probabilities between pluralism and corporatism for unemployment benefit retrenchment

Figure 4.7: Predictive margins of `ueb` for values of `growthcrisis` across corporatist and non-corporatist countries. Dashed lines indicate non-significant coefficients. Dotted lines indicate 90% confidence interval.

4.6 Conclusion

The new qualitative labour market reform data used for this paper confirms that continental European economies have over the past thirty years enacted a significant number of regulatory changes to the unemployment benefit system. Reforms were not only of a marginal, but also of a structural nature. This adds emphasis to the research question as to what drives controversial structural reforms in Europe's political economies. Starting point of the paper was the observation that, in many European countries, corporatism grants socio-economic interests – conventionally those of employer organisations and trade unions – privileged access to the policy-making process. This gave rise to the conjecture that reform trajectories of these countries are also a function of these stakeholder interests. It also gave rise to the conjecture that factors that are conventionally thought to determine structural reforms – government partisanship and economic crises – are likely to play a less significant role in corporatist countries than they do in pluralist countries.

Results of the empirical investigation can be summarised as follows: First, privileged interests – the utility of employer organisations and trade unions – do indeed matter for the reform trajectories of the employment benefit systems in corporatist countries. There is also evidence for the reverse implication of the theory, namely that corporatist interests have no effect on reform trajectories in pluralist countries. More specifically, employer organisation and trade union interests do not seem to affect the likelihood of employment benefit system reforms in pluralist countries.

Second, the empirical investigation also revealed that broader political institutions and economic conditions – commonly held to be important determinants for structural reform – do indeed matter in pluralist countries. However, they do not (or at least not significantly) matter in corporatist countries. More specifically, there is some evidence that government partisanship significantly impacts labour market reform trajectories in pluralist systems, while there is no such evidence for corporatist countries (Immergut & Abou-Chadi 2010, for a similar finding). There is also evidence that growth crises has a significant impact on structural reform trajectories in a pluralist countries, but not in a corporatist setting.

These findings invite more empirical research on the impact that organised interests have on structural reforms and other policies in European countries. To begin with, the understanding of the political objects of these organised interest groups remains limited. The employment relations literature holds that peak level employer organisations represent the interests of their constituents in the manufacturing sector. This assumption may be too restrictive, particularly for the past decade. Many European countries have experienced a gradual transformation from manufacturing to service economies. Employer organisations may be pressed to incorporate the interests also of firms in other sectors of the economy. Further, this paper used manufacturing profits as proxy for the interests of firms. This approach may also prove to be overly simplistic. Other success indicators – such as return on investment – or other indicators entirely – such as management salaries – may well be important elements of the employer organisation's utility function.

Also, this study was limited to one particular labour market institution, namely the unemployment benefit system. The question quickly arises whether the findings also translate to other institutions of the labour market and wider socio-economic structures.

In closing, it may be noted that the above regressions were also run for the indicator of reform of employment protection legislation `epl` coded from the fRDB/IZA database in the context of this study. They are not presented here for reasons of parsimony. Results broadly confirm the findings presented in this paper, confirming evidence that privileged interest representation does indeed have a intermediating effect on the determinants of structural labour market reforms in Europe.

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4.A Econometric considerations

Specifying a model for the data and hypotheses described in Sections 2 and 3 poses some technical challenges. First, the ordered, categorical nature of the dependent variable – years with and without structural reforms – precludes the use of standard linear regression models. While non-linear, logit and probit models for binary outcomes are well established, this is somewhat less true for non-linear models with ordinal dependent variables. The technical toolbox in computational statistical packages is certainly relatively smaller. More generally, non-linear models bear more statistical pitfalls, including the problem of how to correctly interpret coefficients or how to best measure the fit of the model (Hoetker 2007). Given these challenges, Mood (2010) suggests using a 'Linear Probability Model' for regressions with ordinal dependent variables – in effect a simple OLS model, in which coefficients are interpreted as probabilities. However, the error terms of the 'Linear Probability Model' violate the homoskedasticity and normality of errors assumptions of OLS regression, resulting in invalid standard errors and hypothesis tests (Agresti 2010). This allows only for the relative comparison of coefficients (Geishecker & Riedl 2010). In short, there does not seem to be an easy way around applying a non-linear regression model.

Second, the data is organised as panel data by years and by countries. While regression models for panel data are relatively well established, this is not true for logit and probit regression models with ordinal dependent variables. Luo & Wang (2008, 31) write that 'compared with those extensively studied panel data models for continuous response, much less has been done for binary panel data, and even less has been done for ordinal panel data, which are typically encountered in real practice (...). Thus, real applications call for effective methods for ordinal panel data modelling.' Several user-written models are available for Stata, which are, however, either not well established (such as regoprob2 by Pfarr et al. 2010 or feologit-buc by Baetschmann et al. 2011) or only allow for random effects estimation (gllamm by Rabe-Hesketh & Skrondal 2004). This paper follows the recommendations of Rabe-Hesketh & Skrondal (2008) for models with fixed effects estimation and uses country cluster-robust standard errors in the standard ologit framework of Stata. Additionally, country specific effects are absorbed by the wide use of indicators that provide a measure of deviations from country-specific trends.

Third, to establish how determinants for structural reform vary across a pluralist and corporatist system, the model specification requires a group comparison. One possibility is to include a group dummy variable and then predict the core variable effect on the dependent variable for the two different values of group variable. This method gives an indication of how the group membership affects independent variables. Including a group dummy variable changes the intercept of linear estimator within the core function of the logit or probit model. It does not, however, allow for different coefficients across the two different politico-economic groups. For this reason, this method is thought to work best for studies interested in the outcomes across groups, rather than studies investigating the difference of determinants across groups (Kleinbaum 2010).

A second, widely used possibility is to run two separate estimations for observations in either of the groups. While this approach is generally permissible, it has drawbacks particularly in non-linear models. Allison (1999) shows that cross-estimation comparisons of coefficients are only viable for logit and probit models if the variance of the error terms is the same. Hoetker (2004, 17) notes, 'in the presence of even fairly small differences in residual variation, naive comparisons of coefficients [across groups] can indicate differences where none exist, hide differences that do exist, and even show differences in the opposite direction of what actually exists.' Building on the work by Allison, Williams (2009) suggests using heterogeneous choice models to compare coefficients of non-linear regression models across groups.

A third possibility is to interact explanatory variables in the model with the group dummy variable. This approach has been referred to as a 'dummy-variable-interaction model' (Allan & Scruggs 2004) or a 'fully dummy-interactive model' (Kam & Franzese 2007). Interaction models explicitly model the 'moderating' or 'intermediating' effect of, for example, different institutional environments on causal relationships. Further, pooling the data in a single estimation 'borrows strength from the other subsamples(s) to obtain better (i.e., more efficient) standard error estimates' (Kam & Franzese 2007, 109). Probably also due to their intuitive appeal, interaction models are becoming more widely used in the social sciences (Franzese 2003).

Interaction models are not without problems either, however. Interaction terms have commonly been used and interpreted wrongly, even in linear models (Braumoeller 2004, Brambor et al. 2005). In the context of non-linear models they are subject to on-going debate among statisticians. Ai & Norton (2003) point out that the interpretation of interaction terms in linear models does not carry over to non-linear models. The non-linear transformation of the linear core-function in logit and probit models means that a change of the marginal effect of a covariate on probabilities depends not only on its own value, but also on the values of all other covariates. Thus, 'the group differences can be significant at some values of the predictor, while not significant at others. This complicates things for the data analyst since there might not be a simple answer to the question of whether the effects of a variable are the same for both groups' (Long 2009, 9). Whether this problem pertains also to the group dummy-interaction model is contested (Kolasinski & Siegel 2010, Karaca-Mandic et al. 2012). Against this background, Buis (2010) calls for the direct interpretation of odds ratios rather than the non-linearly transformed probabilities. Most authors, however, suggest a graphical analysis of predicted probabilities (Norton et al. 2004, Long 2009, Greene 2010, Williams 2012). Berry et al. (2010, 265) writes: 'Testing the statistical significance of the product term is necessary to confirm a hypothesis that independent variables interact in influencing the unbounded latent dependent variable. But this test does not shed light on the nature of the interaction between the variables in influencing Pr(Y). Whether the variables interact in influencing Pr(Y) should be tested by direct examination of estimated effects on Pr(Y).'

In summary, conducting a comparison of estimators across groups in a model with an ordinal dependant variable and panel data requires an analysis that is very much at the current frontier of statistical methods in the social sciences. The paper uses a group dummy-interaction, ordinal logit model. It exercises particular caution when interpreting results, providing a graphical analysis of predicted probabilities to confirm evidence provided from regression estimates. It runs the specification as a 'Linear Probability Model' and as a heterogeneous choice 'Ordinal Generalized Linear Models' to ensure that results are not an idiosyncrasy of the ordinal logit model (see Footnote 25 for results).

4.B Data sources

`ueb` The indicator is based on Anelli et al. (2011). For details of the coding please refer to Section 3 of the paper.

`corp` The indicator is a dichotomised version of the corporatism indicator provided by Siaroff (1999). This provides a binary indicator for pluralist countries (`corp`=0) and corporatist countries (`corp`=1). For a detailed discussion please refer to Section 3 of the paper.

`emplutil` The indicator for utility of employer organisations is based on sectoral data from the STAN Structural Analysis Database (OECD 2010a). The database allows the calculation of gross nominal operating profits (added value minus wage and non-wage labour costs) for the manufacturing sector. The `emplutil` indicator provides the percentage deviation of gross real operating profits from the linear trend between 1980 and 2007.

`unionutil` The indicator for utility of trade unions is based on sectoral data from the STAN Structural Analysis Database (OECD 2010a) and the OECD Tax Database (OECD 2010b). More specifically, first, the take-home income of a representative, employed manufacturing worker is calculated, using data from from the OECD's 'STAN Structural Analysis Database' and Tax Database. The STAN data allows calculating the average gross nominal income of employees by sector by dividing the wages and salaries by the number of employees in the sector. This average gross income is used to calculate – for a representative worker – the income taxes on national and sub-national level (the latter, where applicable) as well as the social security contributions. Given that most taxes and contributions are calculated progressively, this requires calculating the public dues for each tax bracket individually. Taxes and social security contributions are then subtracted from the gross income. Second, using the average gross nominal income and information on the gross replacement rate from the OECD Tax Database (OECD 2010b), income for an unemployed manufacturing worker is calculated. Third, take-home income for an employed manufacturing worker is weighted with percentage of the workforce in employment, while income for an unemployed manufacturing worker is weighted with the percentage of the unemployed workforce, using data from Armingeon et al. (2010). Fourth, weighted employment and unemployment income are summated. Fifth and finally, the sum is divided by price levels to obtain an indicator in real terms, using OECD (2011). Finally, the `unionutil` indicator then provides the percentage deviation of net real income from the linear trend between 1980 and 2007.

`partisanship` A commonly used measurement for government partisanship is Beck et al. (1991), which provides a categorical variable for dominant government party orientation with respect to economic policy. A government may thus be 'left', 'right' or 'centre'. This indicator, however, leaves relatively little scope for coalition governments, which are a common feature of many European countries with a proportional representation voting system. Armingeon et al. (2010) provides an indicator that measures the percentage of cabinet posts held by social-democratic and other left parties, weighted by days.

`vetopoints` Beck et al. (1991) provides an indicator that counts all formal veto players in the system, adding veto points for an independent chief executive, for a 'cohabitation' government, for each chamber of the legislature held by the opposition and for every party in the government coalition, among others.

`electyear` To account for electoral pressure, a dummy variable for years preceding a national parliamentary election is included. A list of all election dates in provided by Armingeon et al. (2010).

`uniondensity` An indicator for union density – the ratio of the number of workers and employees that are trade union members, and the total number of workers and employees in the workforce – is provided by Armingeon et al. (2010).

`outputgap` An measure of the output gap, the difference between actual GDP and potential GDP, is available from the Economic Outlook (OECD 2011). The indicator is calculated as the annual deviation from country-specific trend over the available time series. Note that a positive output gap indicates that the economy is growing above potential, while a negative output gap indicates that growth is below potential.

`unemployment` An annualised rate of unemployment is available from the Economic Outlook (OECD 2011). The indicator is calculated as the annual deviation from country-specific trend over the available time series. The time series starts for Greece in 1995 and for Ireland in 1990.

`deficit` An annualised measure of general government deficit/surplus as a percentage of GDP is available from the OECD Economic Outlook (OECD 2011). The indicator is calculated as the annual deviation from country-specific trend over the available time series. The time series for Greece starts in 1993.

`uebtotal` An indicator for the summary measure of benefit entitlements for 1961 to 2012 on a biannual basis from (OECD 2010b). Missing data for the even years are imputed.

General note: Data up until 1990 is for West Germany.

4.C Figures and tables

Variable	N	Mean	Std. Dev.	Min.	Max.
corp	420	0.500	0.500	0	1
emplutil	395	0.000	0.137	-0.468	0.403
unionutil	381	0.000	0.048	-0.143	0.173
partisanship	420	0.404	0.383	0	1
growthcrisis	406	0.189	0.392	0	1
uebtotal	406	31.573	13.004	0.347	64.944
electyear	420	0.290	0.454	0	1
vetopoints	420	4.454	1.578	2	16
uniondensity	420	42.627	21.944	7.6	87.412
outputgap	420	0.000	2.154	-7.924	7.520
unemployment	393	0.000	1.995	-7.685	9.160
deficit	371	0.000	2.408	-10.04	7.1

Table 4.4: Data description

UEB	Model 1		Model 2		Model 3	
	corp=0	corp=1	corp=0	corp=1	corp=0	corp=1
emplutil	1.101	-5.913***	1.265	-6.791***	0.080	-4.509**
	(1.235)	(0.946)	(0.999)	(1.130)	(1.069)	(1.968)
unionutil	0.000	-6.850**	-0.484	-8.449**	-2.454	-7.203**
	(2.364)	(3.219)	(2.691)	(3.301)	(3.114)	(3.414)
partisanship	-0.598**	0.282	-0.704*	0.592*	-1.177***	-0.032
	(0.242)	(0.326)	(0.430)	(0.361)	(0.300)	(0.204)
growthcrisis	1.398**	-0.565	1.499**	-0.677	1.382*	-0.424
	(0.660)	(0.560)	(0.654)	(0.605)	(0.743)	(0.654)
vetopoints			-0.052***	-0.071		
			(0.019)	(0.121)		
electyear			-1.193**	0.204		
			(0.564)	(0.285)		
unionpower			-0.031***	-0.015***		
			(0.006)	(0.005)		
outputgap					-0.253**	-0.061
					(0.125)	(0.254)
unemployment					0.286***	-0.102**
					(0.096)	(0.047)
deficit					0.073	-0.204**
					(0.089)	(0.096)
uebtotal	0.017**	0.015	0.039***	0.022**	0.010	0.007
	(0.009)	(0.011)	(0.008)	(0.010)	(0.008)	(0.016)
corp	0.001		1.660**		0.077	
	(0.712)		(0.858)		(0.924)	
cut1	-2.588***		-1.875***		-2.669***	
	(0.486)		(0.692)		(-5.584)	
cut2	2.474***		3.498***		2.170***	
	(0.416)		(0.650)		(0.406)	
N	353		353		331	
McFadden	0.066		0.103		0.092	

Table 4.5: Regression estimates for `epl`, SE in brackets below the coefficients, * p<0.1, ** p<0.05, *** p<0.01. Note: To facilitate the analysis, tables present overall effects of the explanatory variables on unemployment benefit system reforms in the pluralist group and the corporatist group, rather than the interaction coefficients. Overall effects for the group `corp` = 1 were calculated by means of a linear combinations of estimators ('lincom' command in Stata).

Conclusion
A new view on the political economy of structural reforms in neo-corporatist European countries: summary of findings, limitations and implications

5.1 Summary

Scholars across the social sciences accept that the institutional structure of a political economy matters for its socio-economic performance. If institutions matter, so must institutional change: 'Institutions provide the incentive structure of an economy; as that structure evolves, it shapes the direction of economic change towards growth, stagnation, or decline.' (North 1991, 97). Governments must therefore have an immanent interest in benignly shaping the institutional structure of their countries by designing structural reform policies – be they regulatory or deregulatory – with the aim of steering the political economy towards economic growth and prosperity rather than decline and poverty.

This PhD project began with two observations on the reform trajectories of Europe's political economies that are puzzling in light of this consideration. First, none of the continental countries in Western Europe followed the paradigmatic liberal market reforms of the Anglo-Saxon countries in the 1980s. This observation raised questions because – in the three decades following the emergence of the so-called 'neo-liberal' paradigm – these supply-side reforms were widely held to enhance growth and employment. The broad policy consensus also informed international policy coordination, such as the European Union's Lisbon Strategy.

Second, non-convergence towards the Anglo-Saxon liberal market economy model was long interpreted by social scientists as institutional inertia in continental European countries. This has turned out to be incorrect. Rather, reform paths of this group of countries exhibit considerable variation in terms of extent and timing of structural reforms. Hemerijck (2012, 40) confirms that '[t]he overall scope of social reform across the member states of the European Union [...] is heterogeneous, disparate, and uneven.' This is puzzling, given that many of the continental European countries are conventionally thought to be quite similar regarding their political and economic structures and are thus expected to react similarly to a changing socio-economic environment.

These observations motivate research as to the factors that determine whether or not structural reforms are implemented in European countries. The discussion of the political economy literature and its findings in the Introduction to this PhD project revealed that none of the conventional approaches to explaining structural reforms – macroeconomic conditions in general and economic crises in particular, government partisanship, electoral pressures, the veto power of governmental bodies or interest groups – can, by themselves, account for the diverse reform trajectories in Europe.

Against this background, this PhD project presented three research papers on the political economy of structural reforms in Europe. It started off with an in-depth examination of Germany in the first paper, in many ways an exemplary continental European country. Before the overhaul of many of its welfare and labour market institutions in the early 2000s, the country was known for its enigmatic resilience against reform in spite of long periods of low growth and growing unemployment. With the help of an augmented veto player framework, the paper identifies three pivotal veto clusters within the German political economy – namely the veto points within the federal government, the federal legislative system and the system of corporatist interest representation – that determine institutional stability and change. Based on expert interviews, news media coverage, policy documents and findings in the literature, the paper compares four distinct political phases between the early 1980s and 2005, assessing the contribution of the three veto clusters on policy stability and reform.[1]

Drawing on insights of Paper One on the *Modell Deutschland* as well as the wider comparative capitalism literature, Paper Two developed a model of institutional stability and change in Europe's 'coordinated market economies'. Coordinated market economies are typically characterised by strong institutional complementarities that allow for a high-quality production regime. Paper Two argued that further characteristics of this economic model are the close coordination of interests that sustain these institutional complementarities and a divided economy that discriminates between so-called 'insiders' and 'outsiders'. The paper consolidated these defining elements of a coordinated market economy in one formal, rational choice model. The comparative statics of the model allow identifying key political economy variables that determine institutional stability and change in this politico-economic model. The results of the model are applied to the reform experience of two countries, namely Germany and Sweden.

Paper Three widened the angle from narrow individual cases in the first two papers to a broader European perspective. The paper employs a new database on social reforms and a probabilistic regression model to conduct a quantitative investigation into the determinants of unemployment benefit system reforms.

[1] In that it compares four distinct episodes of policy-making in Germany, Paper One is a comparative case study. It could almost be described as a very rudimentary Qualitative Comparative Analysis (QCA), 'comparing cases as configuration of set memberships and for elucidating their patterned similarities and differences.' (Ragin 2000, 120)

More specifically, it argues that a different set of political economy factors are likely to affect structural reform probabilities across different types of political economies across Western Europe. In corporatist countries, the institutional preferences of interest groups with privileged access to the political decision-making process are expected to significantly impact reform trajectories. In pluralist countries, conventional political and macroeconomic factors – such as government partisanship and economic crises – as expected to matter more.

The juxtaposition of the three papers of the PhD project highlight clear linkages and a certain logical relationship: First and most obvious, all three papers set out to contribute to the understanding of reform trajectories in one or more countries of continental Western Europe. Second, it could be argued that the three papers loosely follows a 'inductive-deductive research' approach (Teddlie & Tashakkori 2009). They contribute to understanding institutional stability and change by progressing from a theory-building case study (of the German political economy) to the development of generalisable hypotheses (by means of a rational choice model) and then to the broader corroboration of these hypotheses (in a quantitative study). Third, the PhD project could be interpreted as taking a 'Mixed Methods Research' (Tashakkori & Teddlie 2003) approach, in that it combines qualitative analysis, quantitative analysis as well as formal modelling in the three papers. Creswell & Clark (2010, 5) argues that this approach 'provides a better understanding of research problems than either approach alone.'

The linkages between the three papers should, however, not obscure the fact that the three papers exhibit important differences with regard to research question, setup, definitions and result. Table 5.1 on page 204 summarises some of the key elements of the three papers.

Differences relate, first, to the questions addressed by the papers. Each of the three papers addresses a different empirical puzzle. More specifically, Paper One addresses the puzzle of one particular, counterintuitive instance of structural reforms in Germany. Paper Two – more broadly – seeks to understand the impact of interest coordination on the divergence of structural reform trajectories across similar, that is, coordinated market countries in Europe. Finally, Paper Three addresses the puzzle why conventional determinants for structural reforms cannot explain reform trajectories equally across European countries. Dissimilar empirical puzzles result in a slightly different governing question that guides the research in each of the three papers.

Second, distinct research questions subsequently result in a different research setup, with respect to research method, analytical framework and data. Paper One conducts a single country case study of Germany. In terms of analytical framework, it develops an augmented version of the Veto Player Model to systematically evaluate primary and secondary qualitative sources on the German political economy. Paper Two embarks on a theoretical, rational choice exploration of coordination behaviour in coordinated market economies. The resulting game-theoretic model is employed as a analytical framework for a short comparative case study of Germany's and Sweden's reform trajectory. This takes the form of an analytical narrative, which aims 'to assess the predictions and to arbitrate among possible explanations in instances of observational equivalence.' (Arias 2011) Finally, Paper Three uses regression analysis to analyse large-N, cross-country panel data in a probabilistic model.

Results from these three types of analytical frameworks are not easily comparable. While Paper One, for example, establishes a deterministic, causal relationship between structural reforms and political economy conditions in the three veto clusters, Paper Three merely provides evidence of a probabilistic relationship between particular politico-economic conditions and reform outcomes.[2]

Third and arguably most importantly, the papers do not follow the same definition of the subject of investigation, namely institutions and institutional change. Institutions in Papers One and Three are broadly congruent. They are understood to be 'implemented government policy', that is, formally approved rules and procedures that govern the political economy. Institutional change requires an active and explicit change of these rules and procedures. Recall from the Introduction that these two papers follow a historical strand of institutionalism in their conceptualisation of institutions. By contrast, Paper Two squarely follows a rational choice institutionalism tradition by conceptualising institutions as 'equilibrium ways of doing things.' (Shepsle 2006, 23) Institutional change in Paper Two is thus understood as the move from one to another equilibrium.

However, much care is taken to avoid letting the conceptualisation of institutions guide the understanding of institutional change. To varying degrees, all three papers take into account of changes in power relations and changes in institutional preferences – balancing structure and agency – to explain the absence and presence of structural reforms.

[2] For example, the paper does not claim that structural reforms inadvertently follow after an economic crisis in pluralist countries. Rather, economic crisis increase the probability of unemployment benefit retrenching reform, all other things being equal.

Fourth and in consequence of the above, the results of the three papers differ. Paper One identifies political factors in Germany's policy-making process as decisive determinants for institutional stability and change. With its veto cluster analysis, it emphasises the importance of relative political power and institutional preferences as causal for Germany's structural reform trajectory. In Paper Two, political factors play a much less pronounced role. On account of its game-theoretic approach, the paper emphasises strategic choices of political economy actors: trade unions, employer organisations and the government. Strategic choices, in turn, are determined by expected payoffs (given the expected reaction of counterparties). Finally, Paper Three shows that factors for institutional stability and change are distinctly different in corporatist and pluralist political economy regimes. On account of its probabilistic regression model, the paper identifies political and economic conditions which increase or decrease the likelihood of (a certain type of) structural reform.

It should be noted that, while not congruent, results across the three papers are not necessarily inconsistent. Paper One started off with the observation of two decades of institutional stability in the German political economy in spite of repeated growth and unemployment crises. The model in Paper Two explicitly picks up this puzzle and provides a theoretical explanation for the phenomenon. Paper Three shows, more generally, that growth crisis do not seem to impact reform probabilities in corporatist economies. Similarly, Paper One observes that the supply-side Agenda 2010 reforms were implemented by a social democratic rather than – as conventional wisdom would have suggested – a conservative government. Again, Paper Two provides some theoretical intuition for this phenomenon. Paper Three shows, more generally, that government partisanship does not seem to impact reform probabilities in corporatist economies.

While political institutions feature more prominently in Paper One than in Paper Two, the two papers link with respect to the role of corporatist interest representation. By investigating the conditions under which coordination in coordinated market economies is sustained, Paper Two can – to some degree – be understood to provide a more in-depth analysis of the behavioural dynamics in the third, corporatist veto cluster presented in Paper One. Note, particularly, that the constraining power of the corporatist veto cluster in Paper One and the stability of complementary institutions in Paper Two both depend on a social consensus on the economic model.[3] The role of corporatist actors in

[3] In Paper One, the weakening of the consensus on the *Modell Deutschland* led to a

Europe's corporatist, coordinated market economies also features in the third paper, which finds evidence that the institutional preferences of trade unions and employer organisations change the likelihood of structural reforms.

Nonetheless, the three papers are, first and foremost, stand-alone academic contributions. With different research questions, setups, definitions and results, the scope and target audience of the contributions are different. Papers One and Three are a qualitative and a quantitative empirical contributions to the political economy literature respectively. By contrast, Paper Two is primarily a theoretical contribution, which is also targeted towards a public choice readership. The scope of Paper One is clearly limited to the German political economy. With its addition to the Veto Player Model, the paper also makes a theoretical contribution to the political science literature. With the political economy mechanism described in Paper Two, the scope of the contribution is limited to the complementary institutions in coordinated market economies. Paper Three has the widest scope by addressing a number of reform determinants both in corporatist and pluralist political economies in Western Europe.[4]

The following conclusion to the PhD project will embark on drawing some synthesising conclusions from the three papers and develop some theoretical and policy implications. It can be read as an attempt to bridge some of the differences across the three papers.

More specifically, Section 2 presents a synthesis of the findings of these three research papers. It shows how they contribute to answering the questions that the PhD project raised in the introduction, and how they more generally contribute to the understanding of the political economy of structural reforms in Europe. Section 3 will point to some of the important limitations of the research projects and possible avenues for future research. Methodological approach and the findings of the research project also have wider theoretical and policy implications. Section 4 develops some thoughts on the implications of the findings for the established theories of institutional change, drawing in particular on the result of the different theoretical approaches taken in Paper

erosion of inner cohesion of corporatist interest groups and subsequently to a weakening of the corporatist veto cluster. In the game-theoretic model of Paper Two the breakdown of consensus leads to a disintegration of the coordinated economy more directly. Paper Two has a much higher degree of abstraction, which factors out many empirically important political institutions and processes. For a more detailed discussion of how these two approaches may be bridged, please refer to the following Section 5.4.

[4] For a more general discussion of the limitations of the research project, please refer to the following Subsection 5.3.

		Paper One	Paper Two	Paper Three
Question	**empirical puzzle**	Why did a social democratic government implement structural reforms in Germany in 2002 after two decades of institutional stability?	Why do European countries not promptly implement structural reforms that are thought to raise aggregate welfare?	Why do conventional determinants for structural reforms not explain reform trajectory in all European countries?
	governing question	What determines structural reforms in Germany?	What determines structural reforms in coordinated European economies?	What determines structural reforms in corporatist *vis-à-vis* pluralist European countries?
Setup	**method**	single country case study	rational choice exploration	regression analysis of cross-country data
	analytical framework	augmented veto player model	game-theoretic model	probabilistic regression model
	data	qualitative data (interviews, news articles, official documents, secondary sources)	qualitative data (mainly secondary literature)	quantitative data (macroeconomic and political panel data)
Definitions	**institutions**	formal rules and procedures that govern the political economy	equilibrium behaviour	formally approved legislation or binding agreements
	institutional change	legislative change to formal rules and procedures	move to a different equilibrium	formally approved documents that change legislation or binding agreements
Results	**determinants for institutional stability and change**	relative power and institutional preferences of veto points within the three veto clusters (federal government, federal legislative system and corporatism)	strategic choice of coordinating actors (government, trade unions and employer organisations)	utility of interest groups, among others (corporatism), political and economic factors, among others (pluralism)
Contribution	**scope**	German political economy	complementary institutions in coordinated market economies	corporatist and pluralist political economies in Western Europe
	type	qualitative empirical, with a theoretical contribution	theoretical, with an analytical narrative	quantitative empirical

Table 5.1: Key elements of the three papers of the PhD project

One and Paper Two. Section 5 provides some thoughts on possible implications of the research findings for public policy-making in the Europe.

5.2 Synthesis of findings

The key findings of the three papers relate to the pivotal effect of politico-economic systems on structural reform trajectories. More specifically, the research project broadly finds that, in many European countries, neo-corporatist interest representation in the political sphere and interest coordination in the economic sphere significantly affect structural reform policies. An explanation of structural reform trajectories in Europe thus requires an understanding of the functioning of corporatism both in the political and the economic sphere.[5]

Corporatist interest representation in the political sphere

A first conclusion that united the three research papers is that, within corporatist countries, special interest representation in the political sphere determines structural reforms to a significant degree.

Corporatism typically allows specific societal interest groups – conventionally employer organisations and trade unions – institutionalised and privileged access to the process of policy formulation and implementation (Christiansen et al. 2009). Recall that in its discussion of the 'corporatist veto cluster' in the augmented veto player framework, for example, Paper One described in some detail this integration of corporatist actors and the government, which may take the shape of the formal involvement of employer organisations and trade unions in public management, as well as of a strong, informal interlocking between these interest groups and governmental bodies.

To varying degrees, this privileged access allows the corporatist groups to impose their interests on the policy outcome. Paper One explained how both employer organisations and trade unions prevented an overhaul of the German political economy in the 1980s due to their strong vested interests in the well-functioning *Modell Deutschland*. Only after the consensus on an integral part of this model – Germany's 'welfare corporatism' – broke down, did more far-

[5] Note that this reflects the two main strands of corporatism research in political science and political economy, as indicated in the introduction to the research project. The first strand of research investigates corporatist systems of interest representation and its effect on the process of policy-making. The second political economy strand of research places more emphasis on the effect of corporatist institutions on the economic systems, focusing on the effect of (wage) negotiation on productivity, inflation and unemployment.

reaching socio-economic reforms follow. Similarly, Paper Two contended that the stability of institutions in the 'coordinated market economy' depends on the support of corporatist actors. Finally, Paper Three provided some robust evidence that, when employer organisations and trade unions are involved in the policy-making process, they significantly determine the direction and scope of labour market reforms.

By itself, the finding that 'corporatism matters' is certainly not new. The importance of corporatist structures for policy outcomes and social welfare in Europe has been the emphasised by a large political science and political economy literature (Molina & Rhodes 2002). However, as discussed in the introduction to the research project in some detail, the effect of corporatism on reform trajectories remains contested in the political economy literature. One strand of literature interprets corporatist actors – having attained significant formal or informal political power – as additional veto players. It thus attributes an inherent status quo bias to corporatist political economies. A second strand of literature, focusing more on the cooperative nature of the socio-economic decision-making process of corporatist countries, emphasises the tradition of cooperative policy-making in corporatist countries which facilitated rather than obstructed agreement on institutional change.

In contrast to previous contributions, this research project finds that corporatism does not *a priori* imply an inherent bias towards either institutional inertia or flux. Rather, corporatist interest representation is best understood as an overriding of the political interests that conventionally dominate the political sphere, rendering electoral pressures and partisan rifts, for example, less important. Structural reforms are, in consequence, also a function of the interests of corporatist actors. Institutional change depends on whether or not, in the eyes of these actors, an alternative set of institutions seems preferential to the institutional status quo. Countries may thus demonstrate a high degree of institutional stability when structural reforms are expected in view of the broader socio-economic conditions and political debate, and *vice versa*.

This is not to say that other factors do not continue to play a role in structural reform policies, also in corporatist systems. For example, Paper One described how, apart from the corporatist veto cluster, the inner cohesion of the government and the diffusion of political power to the German *Länder* were important explanatory factors for the reform trajectory of Germany over the past decades. Similarly, there was some evidence in Paper Three that political and economic variables may also be significant determinants of unemployment benefit system reform in corporatist countries.

Nonetheless, the understanding of how corporatist interest representation impacts on the policy-making process goes some way to explaining the large variation in the reform track record of continental European countries. In fact, two components may contribute to this variation, namely the mechanism of policy-making in corporatist countries, and the differences in the policy-making mechanism between corporatist and non-corporatist countries.

First, reform trajectories across corporatist countries may diverge even in view of the same international pressures or symmetric socio-economic shocks. Institutional stability and change is closely related to changes of the preferences of the corporatist actors, rather than broader political or economic factors. For example, the narrative presented in Paper Two described how, on the one hand, a change in corporatist institutional preferences emerged and subsequent led to reform in Sweden in the early 1980s, following the increased compression of wage differentials between skilled and unskilled workers. In Germany, on the other hand, a significant structural reform was a longer time coming, in spite of severe socio-economic pressures as both Papers One and Two demonstrate. Here, a change of institutional preferences occurred only in the course of the 1990s, following the rising costs of the welfare state after reunification.

Second, not all continental European countries have corporatist structures. Institutional change in pluralist countries, however, follows different mechanisms than in corporatist countries. Pluralist political economies are characterised by disorganised and competing interests, which are not systematically integrated into the policy formulation and implementation process. This implies that conventional political interests play a bigger role than in a corporatist setting. It can be conjectured, for example, that the interests of government officials are typically linked to party ideology and re-election probability, implying that these factors will be more decisive determinants for structural reform policies. Indeed, Paper Three provided some evidence that variables such as government partisanship and GDP growth crisis have more explanatory power for reform trajectories in pluralist countries.

Interest coordination in the economic sphere

A second summary finding of the research project is that within corporatist countries, the coordination of socio-economic interest in the economic sphere guides the institutional preferences of the special interests to a significant degree.

As described in more detail in Paper Two, on the basis of the Varieties of Capitalism literature (Hall & Soskice 2001b), corporatism allows for the close coordination of interests among corporatist interest groups – conventionally employer organisations and trade unions – and between corporatist interest groups and the government. Coordination replaces the market as an instrument for the allocation of resources in these economies[6], providing the foundation for a particular type of high-quality production regime. One example of this is the *Modell Deutschland*, as described in Paper One. Soskice (1999, 119) accordingly describes 'coordinated market economies' as 'descendants of corporatist economies.'

This industrial regime will significantly steer the institutional preferences of the coordinating interest groups. More specifically, the interest groups will have strong preferences for institutions – labour market regulation, social insurance, and education and training, for example – that complement their particular high-quality industrial strategy. Correspondingly, institutional preferences of corporatist actors will change when a set of institutions no longer complements their strategy. Paper One argued that the coordinating actors withdrew their support for some of the central institutions of Germany's welfare corporatism because the cost of maintaining the institutional status quo became relatively expensive *vis-à-vis* alternative institutional arrangements. More generally, Paper Two contended that the preference for coordinating actors for a particular set of institutions depends on expected manufacturing profits and blue-collar wages from these institutions. Finally, Paper Three found that, within a corporatist setting, a deviation from long-run trend of manufacturing profit or a deviation from long-run trends of manufacturing workers' income increases the probability of employment protection legislation reform.

It is easy to see that this finding – in conjunction with the findings on corporatist interest representation in the political sphere – suggests that corporatism provides the relevant actors with more influence over the design of the institutional environment in which they operate than is conventionally allowed for in the literature. In particular, it suggests that institutional complementarities are the result of design or re-design just as much as the result of mere

[6] For example, trade unions and employer organisations centrally negotiate agreements on wages, working hours and conditions for industries or the whole economy. At the same time, the public-sector share in the economy is typically higher in corporatist countries. More areas of public life are organised by the state or para-public bodies in coordinated than in liberal market economies.

‘discovery’ (Streeck 2004).

This understanding contributes to explaining the puzzling institutional non-convergence of continental European countries towards a liberal market model in spite of strong international pressures and episodes of economic underperformance. Coordinated economies did not follow their Anglo-Saxon counterparts in implementing far-reaching deregulatory reforms, simply because this was not in the interest of the coordinating actors. More specifically, a situation is easily conceivable in which corporatist agents retain their preference for a particular institutional status quo even in view of low or negative economic growth and rising unemployment. This would be the case if adverse economic developments remained contained within segments of the economy that are not represented by the corporatist interest groups. As long as the set of institutions complements the strategy and thus maximises the utility of the coordinating actors, this set of institutions will enjoy support. Using the same argument, even further institutional divergences of European economies from the liberal market benchmark can plausibly be explained.

In that it explains the non-convergence of the continental European socio-economic model towards its Anglo-Saxon liberal market counterpart, this argument is congruent with the Varieties of Capitalism literature. However, this literature also argues that by exploiting its ‘comparative institutional advantage’ in international trade, the coordinated market economy presents a second, welfare-maximising type of economy next to the liberal market economy. Accordingly, Hall & Soskice (2001a, 58) argues that governments may be expected to ‘be less sympathetic to deregulation because it threatens the nation’s comparative institutional advantage.’

In this particular aspect, this project follows a slightly different line of argument than the Varieties of Capitalism literature, relaxing its relatively strong assumptions on the welfare implications of a coordinated market economy. By combining the concept of institutional complementarity with non-encompassing corporatist interest representation, it entertains the possibility that the comparative institutional advantage pertains only to part of the economy – typically the export-led manufacturing sectors. It is thus easy to imagine a situation in which non-convergence – while in the interest of the corporatist actors – does not maximise the welfare of the whole country.

5.3 Limitations of the research project

The following section will discuss some of the most important limitations of the research projects regarding the scope of its explanatory power as well as the exclusion of considerations regarding welfare implications of corporatist structures and structural reforms.

Scope of the research project

The inductive-deductive approach taken by this research project has the drawback that it narrowed the focus of the research project on a particular explanatory variable in particular policy field, namely the effect of privileged interest representation as it prevails in continental Europe on labour and welfare reforms. More specifically, the study in the first paper of the project narrowed the focus of the project to the ‘corporatism’ variable, which was found to be a decisive determinant of institutional stability and change in Germany over the past decades.

Note that starting off with a case study of a pluralist country would have produced very different findings on the determinants of structural reforms and resulted in a different focus of the PhD project in the subsequent research papers. Although the third paper was able to generalise some hypotheses on the significance of corporatist systems of interest representation for reform trajectories, the setup of the research approach clearly limited the scope of the research findings, in terms of geography and policy area.

The main finding of the research project pertains first and foremost to countries with corporatist traits. Clearly, the findings of Papers One and Two in particular have little to no explanatory power for the reform trajectories of countries without privileged and institutionalised interest representation. Paper Three does find some evidence that in more pluralist European countries conventional determinants for policy-making, such as macroeconomic conditions and government partisanship, are significant factors for reform policies. However, the project refrains from developing more explicit and elaborate theories on what determines structural reforms in this second group of European countries.

Strictly speaking, the PhD project thus only answers half of the question on reform trajectories in European countries that it laid out in the Introduction. While it helps to explain reform trajectories in countries such as Germany, the Netherlands, Belgium, Austria, Sweden, Finland and possibly others, its contribution to the understanding of reform trajectories in the more pluralist countries of Europe remains limited. To fully understand the diverse reform trajectories in Europe, more research is also needed on the political economy of structural reforms, particularly in this second group of countries. Important questions for future research relate particularly to the difference between corporatism and other forms of interest representation in their effect on reform trajectories. Under which conditions, for example, do interest groups in pluralist countries develop veto powers that could potentially explain the reform inertia in Southern European countries such as Greece, Italy and Portugal?

Second, this PhD project has focused on the organisation of the labour market as well as some of the adjacent policy areas, including the social security systems (unemployment and pension insurance), which also have significant impact on the incentives in the labour market. These policy areas have been identified as most controversial politically in the introduction of the PhD project.

A priori, it is not clear, however, if and how far the findings on the determinants of structural reform in this policy area will hold in other policy areas. Not only may the interests of corporatist actors vary significantly across policy areas. There may indeed be policy areas on which the typical corporatist actors – employer organisations and trade unions – have no dedicated policy preferences. In these policy areas, other societal interest groups – for example, the churches, environmental and conservation organisations or the organisations of ethnic minorities – may be important corporatist actors. Alternatively, and if no such privileged interest representation exists in a particular policy area of an otherwise corporatist country, the policy-making may follow more pluralist ways.

Third and as indicated in the introduction, the research project has focused on Europe. However, corporatism as a politico-economic system is not limited to this continent. Japan and South Korea are commonly referred to as typical examples of the Asian variant of corporatism, in which social partnership plays a prominent role (Kim 2008). In Latin America, a unique form of state-led corporatism has developed, which diverges from European corporatism (Wiarda 1997, 77ff.). Future research will have to investigate if and how far the findings on the impact of corporatism on reform trajectories are transferable to corporatist systems outside of Europe.

Welfare implications of corporatist structures and structural reform

The main focus of this research project has been the positive effect of corporatist structures on the political economy of structural reforms. Normative considerations on the effect of corporatist structures on social welfare in the political economies of Western Europe have played a subordinate role.

A normative discussion of neo-corporatist structures can be traced back, for example, to the Ordo-Liberal School of the early 20th century in Germany and Austria. Eucken, for example, criticised the systematic interlock of the political and the economic system in the political economy of the Weimar Republic. He argued that the system was abused to 'improve the position of one group in the capitalist markets' (Eucken 1932, 306, original in German), which not only impaired the functioning of the market economy – Eucken sees a causal link with the Great Depression – but also undermined the stability of the democratic system. In this seminal contribution on the 'Rise and Decline of Nations', Olson similarly argued that 'special-interest organizations and collusions reduce efficiency and aggregate income in the societies in which they operate and make political life more divisive.' (Olson 1982, 47)

Others, however, have defended the European socio-economic system and the corporatist structures for their ability to produce more stable and equitable democratic societies. Prominently, Lijphart (1999, 301) finds that 'consensus democracies do clearly outperform the majoritarian democracies with regard to the quality of democracy and democratic representation as well as with regard to what I have called the kindness and gentleness of their public policy orientations.' As discussed in Paper Two, the comparative capitalism literature, in particular, has argued that economies in which socio-economic groups strongly coordinate their interests do not necessarily perform worse in terms of economic welfare than economies in which resource allocation is organised purely by the market mechanism.

Some reflections on the economic welfare performance are included in the model presented in Paper Two. Following the logic of Olson (1982), it provides a consolidation of the two arguments, namely that – depending on the degree to which the corporatist groups encompass larger or smaller proportions of interests – corporatist structures may be either welfare improving or welfare reducing. However, this merely indicative normative finding features only in the sidelines of this research project. More research on the overall welfare effects of corporatist, coordinated market economies *vis-à-vis* pluralist, liberal market economies would be of significant academic and public policy interest.

It should not be left unmentioned that the research project remains almost entirely agnostic to the normative question as to whether supply-side reforms are at all desirable in continental Europe. The project started out on the premise that there has been and – as it turns out – there remains a broad European and international political consensus on supply-side reforms. The project subsequently investigated positivist issues of reform implementation only.

Many economists, in particular, maintain that Germany's bloated welfare state and labour market overregulation, for example, continued to weigh on economic growth and employment (Siebert 2003, Sinn 2007). In France, remnants of the 'dirigiste' economic system and militant trade unions had similarly adverse effects (Baverez 2003, Duhamel 2003, Levy 2008). Overregulation, public mismanagement and insufficient legal security had made Italy the 'sick man of Europe' (Ariemma 2003, Della Sala 2004, Simonazzi et al. 2009). The 2003 'Sapir Report' on how to improve the economic performance in the EU finds that 'what is required is a massive change in economic institutions and organisations, which has not yet occurred on a large scale in Europe' (Sapir 2003, 2). Similarly, Alesina (2006, 3) warn that '[w]ithout serious, deep, and comprehensive reforms Europe will inexorably decline, both economically and politically.'

On the whole, there are, however, surprisingly few academic studies on the effect of liberal market reforms on economic prosperity. Some contributions have argued that liberalisations will improve the economic performance in Europe (Blanchard & Giavazzi 2003, Blanchard 2004, OECD 2005, Ernst et al. 2006, Berger & Danninger 2007, Tressel 2008) and others that there is no evidence for an improvement of economic conditions through liberal market reform (Baker et al. 2004, Orenstein 2009). Tommasi (2004) points to the fact that institutional change may both improve or worsen the institutional structure of an economy, and warns that structural reforms should not become an end in themselves.

5.4 Implications for the theories of institutional change

A first set of broader implications of this research project relates to the theories of institutional change. The introduction to this PhD project provided a discussion of different conceptualisations of institutions and institutional change in the political economy literature, particularly in the rational choice institutionalism and historical institutionalism strands of the literature. This research project put forward papers that follow these distinctly different theoretical approaches. Using the two approaches to address a similar research question, while making no claim to provide a synthetic theory of institutional change, highlights some important theoretical implications.

Implications for theorising the time perspective on institutional change

The first theoretical implication of contrasting a historical and rational choice approach to institutions is that it may be appropriate to attribute – quite counter-intuitively – a short-term perspective to historical theories of institutional change and a more long-term perspective to rational choice theories of institutional change.

Conventionally, rational choice or 'calculus' approaches to institutions are thought to relate to a short-term time horizon, while historical or 'cultural' approaches are thought to relate to the longer-term. Katznelson & Weingast (2005, 5), for example, finds that '[r]ational choice scholars especially prize the analysis of specific time-bound, events – an election or a piece of legislation, for example. The penchant of historical institutionalists for longer temporal horizons spanning decades or more makes them a good deal more likely to encounter and analyze situations in which preferences on several dimensions evolve over time and in which the set of actors is less likely to remain stable.' (Bannink & Resodihardjo 2006, for a similar argument)

However, this research project would suggest reversing this perspective, particularly in the analysis of institutional change. As discussed above, institutional change in historical institutionalism is, on the one hand, linked to power constellations. These typically relate to a particular political context and may change relatively quickly, for example, due to electoral outcomes or changes in political leadership. Institutional change in the rational choice framework, on the other hand, requires shifts in institutional preferences, which are linked to more gradual changes in institutional complementarities and – consequently – to the expected payoffs from institutional arrangements. Roland (2004) similarly distinguishes between 'fast-moving' and 'slow-moving' institutions, formal rules adopted by a centralised, political process and cultural norms and pattern behaviours respectively.

To illustrate this difference, consider the differences in the theoretical approaches taken in Paper One and Paper Two of this PhD project. In that these rules and procedures are assumed to be carried forward from past political choices, Paper One broadly follows a historical institutionalist tradition. In its analysis of institutional stability and change, the paper accordingly analysed the balance of power between the 'blocked' government and coalition partners, federal entities and corporatist actors in particular. Note that this analysis relates to four relatively short episodes of policy-making in Germany, in which power relations shifted significantly.

Note further that Paper One also finds evidence of more subtle shifts in institutional preferences and a weakening of the consesus for the 'Modell Deutschland' that only subsequently contributed to the shifts in relative power. More specifically, the loss of constraining power of the corporatist veto cluster, which opened a window of opportunity for the passing of the Agenda 2010 reforms in the early 2000s, was the result of growing discontent with the institutional arrangements. 'Declining support for the German economic model and its cooperative institutions substantially weakened the stability of its corresponding corporatist structures.' (Paper One, 91)

This finding corresponds with the tradition of rational choice institutionalism, which construes institutions as equilibrium behaviour and institutional change is determined by shifts in the preferences of politico-economic actors. Paper Two, for example, describes how shifts in the cost and benefit structures for corporatist agents resulted in a denial of support for the cooperative institutional equilibrium, and were thus important underlying drivers of institutional change. These shifts of institutional preferences could be interpreted as declining support for the institutional status quo, which would gradually increase the socio-political pressures for structural reforms. In other words, if one or more agents want 'to play according to different rules [...] then the rules are not in equilibrium and the "institution" is fragile.' (Shepsle 2006, 26)[7]

Against this background, one could go so far as to suggest that the combination of the two time perspectives on institutions and institutional change – namely, 'institutions as equilibrium behaviour' in the long-term, 'institutions

[7] To refer again to the simple example of traffic rules for the purpose of illustration: It was argued that right-hand or left-hand driving can be conceptualised as equilibrium behaviour. Should – for one reason or another – particular interest groups feel that it would be better to switch to the alternative side of the road, over time political pressures would arise to change the driving side. However, power relations between the actors at a given time will decide whether a country continues driving, say, on the left-hand-side or – as did Sweden, for example, in 1967 – switch to the right-hand-side.

as exogenous constraints' in the short-term – may present a way forward to construct a comprehensive theory of institutional change, taking into account both 'the willingness to act (agency) and the ability to do so, as a result of diminished limits of action (structure)' (Bannink & Resodihardjo 2006, 11).

Implications for theorising the change of complementary institutions

Second, the change of a set of institutions that provide actors with complementarities may be better understood in a rational choice than in a historical institutionalism framework.

As indicated above, institutions can generally be construed either as an exogenous constraint on actors' choices or as endogenously defined, equilibrium behaviour, broadly following historical or rational choice institutionalism respectively. In Paper One and Paper Two, the complementary set of institutions of a coordinated economy – the wage bargaining system, the vocational training system, labour market regulation, unemployment benefits, the corporate and personal income tax system etc. – were alternatively conceptualised as the former and the latter. More specifically, in Paper One these socio-economic institutions are interpreted as exogenous, formal rules and procedures that govern the German political economy. In Paper Two, they are interpreted as an 'equilibrium ways of doing things' (Shepsle 2006, 23). Namely, the set of institutions is understood as contributions of the agents in the model to maintain a high-quality, coordinated economy. The two interpretations are congruent, in that they guide and constrain the behaviour of individuals or groups within society.

However, the two conceptualisations are very different in terms of their implications for institutional change. While power relations remain an important determinant for institutional stability and change of 'historical institutions', the key determinant for change of 'rational choice institutions' is preferences. In terms of their influence over institutional stability and change, one could speak of the 'positive' and 'negative' veto power of the politically relevant actors. In the interpretation of positive veto power, institutional change requires the agreement of all actors. In other words, all actors with veto power need to say 'yes' to institutional change for this to occur. In the alternative interpretation of negative veto power, institutional stability depends on the active support of the actors. Institutional change follows the withdrawal of support – a 'no' vote – from one or more of the actors.

In view of this finding, there are two points in favour of a rational choice approach to conceptualising the change of complementary institutions. First, an equilibrium approach to institutions allows the capturing of the knock-on effects that the change of one institution is expected to have on other institutions in the presence of complementarities. While generally self-reinforcing, Hall & Soskice (2001a, 63f.) find that institutional complementarities 'raise the prospect that institutional reform in one sphere of the economy could snowball into changes in other spheres as well.' (Deeg 2007, for a similar argument) As Paper Two demonstrated, an equilibrium approach to a set of institutions captures very well how the defection of one actor will lead to a breakdown of the institutional status quo. Note that the 'historical' conceptualisation of institutional complementarities does not provide for this endogenous link within a set of institutions.

Second, the nature of complementary institutions suggests that institutional change is determined more by the presence of a negative veto than the absence of a positive veto. In other words, their change is the result of lack of support from political economy actors. Accordingly, Hall & Thelen (2009, 11) find that 'the durability of an [complementary] institution can rest substantially [...] on how well it serves the interests of the relevant actors. Where an institution fails to serve those interests well, it becomes fragile and susceptible to defection from its rules.'

To understand this, consider that institutional complementarities imply that the presence of one institution reinforces the 'functional performance' (Höpner 2005) of another institution. Where these institutions serve a benign purpose, their co-action thus exponentially increases the welfare of the relevant social entity. It is thus *a priori* in the interests of the relevant actors to coordinate their efforts to build and sustain these institutions. Given that the nature of complementary institutions is 'collective' or 'aggregative', the process of institutional change – at least one that avoids a breakdown of the complementarities – is likely to be cooperative. This suggests an equilibrium approach to these institutions, in which institutional preferences decide on stability and change.[8]

Conversely, institutional substitutes imply that the presence of one institution reduces the functional performance of another institution. These institu-

[8] Note that Paper Two discussed the possibility that a set of institutions may provide benevolent complementarities to one part of the economy, while being costly to another part. In this case, the set of institutions is of a substitutive nature when considering the whole economy.

tions are conflicting, in that one institution or set of institutions infringes on the functional performance of another institution or set of institutions. In consequence, one group is likely to reject institutions that are favoured by another group in the social entity. Given that the nature of substitutive institutions is essentially distributive, the process of institutional change in the case of substitutive institutions is thus likely to be full of conflict. This, in turn, suggests that power relations are important in determining the institutional outcome and that a historical institutionalism approach may be more appropriate in explaining stability and change.

Implications for theorising incremental institutional change

Third, construing institutions as equilibrium behaviour may allow for the conceptualisation of incremental institutional change, shifting the focus away from power-distributional questions to conflicting interests.

Recent contributions to historical institutionalism have criticised the previous literature on institutional change due to its inability to explain reform in the absence of significant exogenous shocks, such as economic or political crisis. However, Streeck & Thelen (2005, 18) find that 'transformative change [is] often the result from an accumulation of gradual and incremental change.' The reasons for this incrementalism may be of a political and/or economic nature. North (1993, 64) writes that 'that the economies of scope, the complementarities, and the network externalities that arise from a given institutional matrix of formal rules, informal constraints, and enforcement characteristics will typically bias costs and benefits in favor of choices consistent with the existing framework.' The literature on gradual institutional change thus argues that change occurs as incremental adjustments to accommodate the changing requirements of the relevant politico-economic actors. Opportunities for these adjustments open up 'when problems of rule interpretation and enforcement open up space for actors to implement existing rules in a new way.' (Mahoney & Thelen 2010b, 4)[9]

The literature also argues that a rational choice conceptualisation of institutions is less suitable for explaining incremental gradual institutional change (Mahoney & Thelen 2010b). This is due to the fact that institutions, interpreted as social equilibria, are extremely stable in the absence of significant

[9] More specifically, the mechanisms by which institutions are adjusted are 'displacement', the gradual replacement of existing with new rules and regulations, 'layering', the introduction of rules in addition or in accompany to existing ones, 'drift', a change in the way rules and regulation are implemented, and 'conversion', the redeployment of existing rules.

exogenous shocks. More specifically, rational choice equilibria are highly self-enforcing in that each agent's behaviour is the best response to the behaviour of the other agents. Quasi by definition, rational choice equilibria preclude the possibility of gradual change. '[I]nstitutional change happens only when *ceteris* is no longer *paribus*, i.e. when shocks exogenous to the system of institutions itself alter the context. Institutional change becomes a response to shocks. Such analyses posit a radical separation between periods of institutional stability and of change [...] that rarely explain well how institutions emerge from disequilibrium at such junctures.' (Hall 2010, emphasis in original)

Paper Two of this research project, however, provides a rational choice framework in which incremental change can be understood. First, the model presented in the paper portrays institutions not as an inherently stable, but as a relatively fragile equilibrium. More specifically, a set of institutions is modelled here as a cooperation game (an infinitely repeated prisons' dilemma-type game), in which agents forgo short-term interests to reap the benefits of coordination. This type of game is intrinsically unstable because each agent has significant incentives to defect, and cooperation only rests on a careful balance of expectations on future benefits and costs of cooperation. In an influential paper on institutional change, Greif & Laitin (2004, 647) argue that 'repeated game theory seems to capture the way that people view their environment and make decisions.'

Second, small changes in the expectations of agents may require an adjustment to the equilibrium to sustain cooperation in this framework. These adjustments can be interpreted as a breakdown of the institutional status quo. This was the approach in Paper Two. Alternatively, however, the breakdown itself could be neglected as a 'theoretical moment', after which a new equilibrium emerges. Given that the old equilibrium will – in most cases – function as a focal point, the new equilibrium is likely to closely resemble the former, however, now taking into account the changed institutional preferences of the relevant actors. Analysing the shift in preferences that causes the equilibrium breakdown and the changes that underpin the new equilibrium allows for a better understanding of the causes of 'dynamic tensions and pressures for change' (Mahoney & Thelen 2010b, 14) that remain side-lined in the historical institutionalism approach to incremental change.

5.5 Implications for public policy in Europe

A second set of broader implications of this research project relate to public policy-making.

Implications for macroeconomic imbalances in the Euro area

First, the findings suggest that introducing a common currency for pluralist and corporatist political economies in Europe may be problematic for the diverging mechanisms of structural adjustment, among other reasons.

A key factor contributing to the ongoing sovereign debt crisis in the European single currency area is the accumulation of significant current account imbalances across the Euro area. In the decade before the crisis, current account deficits were commonly attributed simply to economic catch-up processes in the currency area. Fiscal positions markedly deteriorated across Western Europe during the Great Recession of 2008/2009.[10] However, the public finances of countries with high current account deficits were particularly hard hit. Investors realised that 'the pattern followed by some countries in the last decade, with growth driven by domestic demand and financed with foreign borrowing, was unsustainable, and that the heavy imbalances which had accumulated [...] signalled the existence of solvency problems.' (Giavazzi & Spaventa 2011, 112)

Note that there is a startling congruence in the Euro area between countries with current account surpluses and deficits, and countries with more corporatist and more pluralist political economies. The cumulated current account deficits of Greece, Portugal, Ireland, Spain and Italy since the introduction of the Euro are the highest within the currency union – in fact, they rank among the highest of the world – while the highest cumulated current account surpluses are reported by Germany, the Netherlands, Finland and Austria.[11]

To a significant degree, these imbalances can be attributed to overly optimistic economic forecasts and the subsequent build-up of economic bubbles – particularly in the real estate sector – in the deficit countries (Lane & Pels 2011). However, the imbalances also reflect more structural divergences in overall competitiveness across countries of the Euro area (Belke & Dreger 2011). These have been attributed also to corporatist institutions, for example

[10] This was owing to budgetary effects of automatic stabilisers in the tax and benefit systems, fiscal stimulus packages as well as support provided to the banking sector.

[11] Data source: OECD World Economic Outlook 2011.

in the wage-setting system. Johnston & Hancké (2009) argue that wage negotiations are led by the export sector, wage-setters are likely to practise wage restraint and keep wage growth in line with productivity growth to maintain international cost competitiveness (Boeri et al. 2001, for a similar argument).

In view of the findings of this research project, the divergence in current accounts is likely to additionally be related to the countries' ability to adjust their institutional structure. Paper Three, in particular, provided some evidence that, in more corporatist countries, the scope and direction of structural adjustment is determined to a significant degree by the export-led manufacturing sector. Similar to the logic of competitive wage setting, it is expected that corporatist actors will adjust the institutional structure of their political economy – if and when necessary – with the aim of maintaining or improving international competitiveness. More specifically, corporatist actors will aim to uphold or strengthen the institutional complementarities, thus maintaining the countries' competitive advantage in manufacturing.[12]

More pluralist countries are likely to find it difficult to develop or maintain an institutional structure with complementarities to support a particular type of comparative advantage. As indicated in Paper Three, structural policies in these countries are commonly linked to broader societal interests, electoral pressures and/or partisan politics. For example, labour market reforms – be they regulated or deregulated – following ideological guidelines or median voter preferences rather than considerations of export competitiveness.

In a flexible exchange rate mechanism, the resulting competitiveness imbalances can be equalised though the occasional competitive devaluations of the deficit countries. This route is blocked in a currency union. To prevent a breakup of the Euro area, mechanisms will have to be devised to deal with the competitiveness divergences that result from assembling in a currency union countries that can systematically optimise cost and institutional structures for export competition, and countries that cannot.

Implications for European policy coordination

A second implication of the research project is that European policy coordination – such as the Lisbon Strategy – to bring about structural reform in individual European Union countries is unlikely to work in countries with strong

[12] 'Comparative advantage' is taken to mean a relative (cost) advantage in a particular sector of an entity in international trade. 'Competitive advantage' refers to the (cost) advantage of one entity over another entity within a particular sector. It is equivalent to an 'absolute advantage'.

corporatist traits, unless corporatist actors are either overruled or integrated into the policy formulation process at European level.

In 2010, the European heads of state and government agreed on a successor for the Lisbon Strategy of the period 2000-2010. The European Commission's 'Europe 2020' initiative, a 10-year strategy, aims at supporting 'smart, sustainable, inclusive growth' in Europe. The better coordination of national and European policies is supported by the 'European Semester', a yearly cycle of economic policy coordination, by which the European Commission analyses the Member States' programmes of economic and structural reforms and provides them with country-specific recommendations.[13] Like its predecessor the new European reform agenda contains explicit recommendations on structural reforms of the labour market, welfare institutions and the tax system, among others, which the government of the Member States are asked to implement.[14]

The introduction to this PhD project found that the Lisbon Agenda is commonly perceived as a failure. In view of the insights of the research project, the prospect of the 'Europe 2020' strategy – particularly with regard to its implementation in corporatist countries – is uncertain at best. More specifically, the European system of policy coordination – the Open Method of Coordination (OMC) – is highly unlikely to effectively impact the policy-making process in corporatist countries. The OMC relies on soft law mechanisms such as indicators, benchmarking and sharing of best practice. While there are no hard sanctions, the compliance with mutually-agreed policy targets relies on peer pressure and so-called 'naming and shaming'. These are instruments that depend mainly on reputational costs and benefits for governments. These 'soft sanctions' will, however, be relatively ineffective in countries in which privileged interests dominate the policy process.

Irrespective of the question as to whether it is desirable to implement the European structural reform agenda in corporatist European countries from a welfare perspective, this leaves European policymakers with broadly two approaches. First, the European level can overrule the national policy-making process to ensure the implementation of European policies in corporatist Member States. More specifically, rather than relying on the commitment of the

[13] Again, the European growth strategy combines several economic and social targets, such as raising the employment rate, increasing investment in R&D, reducing levels of poverty, improving levels of education and improving environmental sustainability (Marlier & Natali 2010).

[14] cf. the country-specific recommendations of the Council 2012-2013, `http://ec.europa.eu/europe2020/making-it-happen/country-specific-recommendations/index_en.htm`, retrieved 28.06.2012 2:18

governments to implement the policies agreed at European level, economic policy recommendations can be made binding, reducing the ability of corporatist actors to prevent the structural reform implementation. The recent reform of the European economic governance framework has already seen a move away from the OMC's 'soft' and towards more 'hard' policy coordination. More specifically, the so-called 'Six-Pack' adopted in December 2012 strengthened the debt and deficit rules of the Stability and Growth Pact (SGP), which had been considerably been watered down in its 2005 reform, introduces a mechanism with the aim of preventing and correcting competitiveness imbalances when and where they emerge with the new 'Macroeconomic Imbalance Procedure'.[15]

There is a second possibility for the European-level to improve reform implementation in corporatist countries. Namely, European policymakers could integrate the privileged interest groups – national employer organisations and trade unions rather then the European-level umbrella associations – more closely in the policy formulation process at European level. Involving these actors in the policy formulation process at European level may help to increase political ownership of the reform agenda, thus reducing the likelihood of resistance during the implementation phase of the reform policies at national level. More importantly, involving socio-economic interest groups in the formulation of structural reform programmes formulated at European level would allow the institutional complementarities of the political economy to be taken into

[15] Importantly, it increases the European Commission's powers to impose sanctions on euro area Member States that persistently breaks the debt and deficit rules of the SGP. The so-called 'reverse qualified majority' specifies that a financial sanction recommended by the European Commission can only be prevented if a qualified majority of Member States vote against it. 'EU Economic governance "Six-Pack" enters into force', European Commission press release, MEMO/11/898, 12/12/2011, http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/898, retrieved 28.06.2012 2:18. In case persistent divergences in competitiveness are identified and countries do not follow the reform recommendations of the Commission, financial sanctions can be imposed on euro area Member States, similar to those foreseen in the fiscal surveillance procedure. Whether these instruments will suffice to overcome the political power of special interests in all Member States will remain to be seen.

account.[16] [17]

Implications for the limits to corporatist policy-making

A third policy implication from this research project is that there are likely to be limits to corporatist policy-making, depending on the degree to which the system can accommodate societal interests and on the degree of divergence of interests in society.

Recall that the model presented in Paper Two distinguished two groups within a corporatist political economy, one represented by employer organisations and trade unions and one not represented by the corporatist organisations. Typically, the former group encompasses the large firms and blue-collar workers in the export-led manufacturing sector, while the latter includes small firms and white-collar workers in the services sectors. Paper Three provided evidence for the influence of the former over the structural reform policies in corporatist countries. The services sector has, however, grown substantially in recent decades and represents the bigger share of the economy in all European countries.

This raises the question at which point societal pressures emerge to withdraw the privileged access of the employer organisations and trade unions to the policy-making process. Paper Two argued that welfare systems can be interpreted as mechanisms to pay off outside workers to ensure their support for the 'coordinated economy', which benefits the insider firms and workers. Corporatist policy-making may reach its limits if corporatist organisations encompass a decreasing proportion of the population. Payoffs to the outsiders may be infeasible if the losses for the outsiders from the institutional status quo become too large.

[16] Past efforts to include the social partners in the policy formulation process at European level, particularly through the European Social Dialogue, are commonly seen as window-dressing rather than real stakeholder involvement. Social partners 'have no part whatever to play in the setting of the various guidelines, pillars and targets [...], and their participation has been moved "downstream" to national level, where they are merely expected to implement the policy that has been established well "upstream".' (Gold et al. 2007, 12). It should be noted that according to Article 138 of Treaty on the Functioning of the European Union, however, the EU 'recognises and promotes the role of the social partners at its level, taking into account the diversity of national systems' and 'shall facilitate dialogue between the social partners social dialogue' with the aim of improving economic governance and promoting social and economic reforms.

[17] At the same time, however, it has to be noted that involving national employer organisations and trade unions which represent the export-oriented manufacturing sector in the policy in formulation at European level also risks reinforcing institutional complementarities that do not or no longer maximise the welfare of the economy as a whole.

The formation of protest and political parties independent of the established corporatist interests could be the result of a growing discontent with the corporatist systems. The currently active ‘Occupy Movement’ presents a model of the shape that this anti-corporatist protest may take. A prime concern of the ‘Occupy Movement’ is that the privileged access of large firms and financial institutions to the policy-making process favours a few, while being disadvantageous to the broader population. more specifically, policy outcomes – particularly the policy reactions to the on-going crisis – are thought to disproportionately benefit firms and banks, while undermining democracy and the market economy.

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