POLITICAL ECONOMY OF THE AGENDA 2010 REFORMS: HOW GERHARD SCHRÖDER OVERCAME THE "BLOCKED REPUBLIC"

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Man kann es so oder so machen. Ich bin für so.[i]

(Gerhard Schröder)

1. Introduction

In his first government declaration in October 1982, Chancellor Helmut Kohl announced a "policy of change" (*Politik der Wende*) with the objective of, "reducing the state to its core competences." (Kohl1983).[*] Many expected the Christian-liberal coalition of *Christlich Demokratische Union* (CDU, Christian Democratic Union), its Bavarian sister party the *Christlich Soziale Union* (CSU, Christian Social Union) and the *Freie Demokratische Partei* (FDP, Free Democratic Party) to embark on a radical reform path similar to the one Prime Minister Margaret Thatcher had initiated in the United Kingdom at that time. However, no radical reform of the German political economy followed. Instead, the country's resilience against socio-economic change had become proverbial. With policy changes impossible even in times of economic crises, Germany finally earned its reputation as "the blocked republic" (*Die blockierte Republik*, *Der Spiegel*, 21 September 2002).

Notable political science scholars assume that Germany's complex politico-economic structure obstructs economic reform policy (Kitschelt and Streeck, 2004, p. 31). That is, a multitude of interlocking institutions and agents exert their authority in the process of policy formulation and legislation, effectively preventing a majority-backed government to put into practice any substantial policy change. As a result, it is said that policy change in Germany's political system can only take place incrementally. One of the most prominent theoretical accounts of this incrementalism is Peter Katzenstein's "semisovereign state." Katzenstein

[*] Please find annotations in the footnotes ([1, 2, 3...]) and translations in the endnotes ([i, ii, iii...]).

finds that, "within the constraints and opportunities that characterize the Federal Republic, incremental policy change … is a politically logical choice" (Katzenstein, 1987, p. 351).

However, the Agenda 2010 announced by Chancellor Gerhard Schröder in 2003 seems to contradict this common knowledge about the German political economy. The Agenda 2010 covers a bundle of socio-economic reforms that affect the labor market, the social security system, the tax system and the research and education system (SPD 2003, pp. 6-19). It was hailed by many as the most far-reaching overhaul of the German socio-economic system spanning the entire existence of the Federal Republic. Even critics conceded that the proposed reforms were "more than just a first step in the right direction"[ii] (German Council of Economic Advisors, 2003, p. 2). *The Economist* found that the Agenda 2010 "may be the most ambitious [reform] seen in post-war Germany" (*The Economist*, 18 December 2003). More recently, Chancellor Angela Merkel honored Gerhard Schröder's Agenda policy as "historic" (*Frankfurter Allgemeine Zeitung*, 22 August 2006).

The reception of the Agenda 2010 in the academic literature has been more differentiated. Some dispute its political and economic significance and include it in the list of other incremental structural reforms in Germany.[1] Using Peter Hall's systematization of policy changes, the economic reforms of the two decades between 1982 and 2002 are almost exclusively first- or second-order policy changes, i.e. "cases of 'normal policymaking,' namely a process that adjusts policy without challenging the overall terms of a given policy paradigm" (Hall 1993, p. 279). The Agenda 2010, on the other hand, has undeniably moved Germany's "conservative" welfare state model (Esping-Anderson 1990) towards a model encouraging greater individual responsibility ("liberal model") and more tax-financed social

[1] For example, some consider the Agenda 2010 as only a "moderate reform" (Zohlnhöfer 2006) or "first order changes" to the system (Merkel and Petring 2007), as an "emergency fix" or as being a "badly crafted" alteration to the system.

security ("social democratic model," Egle, 2006, p. 191 and Hassel & Williamson 2004, p. 12). While Merkel and Petring (2007) generally portray the Schröder government as "traditional social democratic," inclined to first-order changes, they concede that its economic policies "show a higher number of elements of a liberal and modernizing social democracy" in the later years (pp. 137). Thus, the Agenda 2010 at least comes close to a third-order policy change, i.e. a "paradigm shift" (Egle and Henkes 2003, p. 89, Trampusch 2005, Schmid 2006 et al., Zimmermann and Eichhorst 2008).

Given that structural reforms have been on the agenda of the Federal Republic since the early 1980s and that Germany's semi-sovereign political structures underwent no major changes, the path-breaking Agenda 2010 reform constitutes an empirical puzzle. It raises the question why the first major attempt to reform the German socio-economic model was undertaken by the second government comprised of the *Sozialdemokratische Partei Deutschlands* (SPD, German Social Democratic Party) and *Bündnis 90/Die Grünen* (Alliance 90/The Greens) (a.k.a., a "red-green" government) and not by any of the Christian-liberal governments or the first government under Gerhard Schröder that preceded it.

This essay will show that the Schröder-led government managed to break the political gridlock and introduce the Agenda 2010 because key institutional structures of Germany's political economy had lost their obstructive powers. In other words, the formerly semi-sovereign state had reclaimed its sovereignty. To understand how this happened, Peter Katzenstein's concept of the semi-sovereign state is first explored as a framework through which to analyze economic policy continuity and change. Within this framework, the causes for constant reform inertia between 1982 and 2002, in spite of varying political constellations and changes in the country's economic structure, are then discussed. This analysis will demonstrate that the Agenda 2010 reforms are predominantly a result of underlying incremental change in the political economy and its effect on the political decision-making process. Finally, the findings of this analysis are summarized and discussed with the aim of better understanding the economic policies of the current grand coalition government of the CDU/CSU and the SPD government under Chancellor Angela Merkel.

2. An Analytical Framework

The complexity of the German political system raises the question, "how political decisions in such an interlocking governmental system are at all possible"[iii] (Holtmann and Voelzkow 2000, p. 15). Indeed, the list of policy constraining agents and institutions is long. Inside 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 competences of the federal government *vis-à-vis* the *Länder* (the federal states). If the opposition party wins elections in a majority of the *Länder*, it also gains a majority in the *Bundesrat* (the veto-yielding second federal chamber). Finally, other outside agents, such as the *Bundesverfassungsgericht* (federal supreme court), comprise further constraining factors. This – by no means exhaustive – overview illustrates that analyzing economic policymaking in Germany requires a multivariable framework.

Tsebelis (1995, 2002) develops a model that abstracts from the highly complex, classic analytical levels of political science by breaking down the problem to one simple question: which agents can potentially prevent a departure from a political status quo? The veto player model states that the greater the number of agents in a system wielding veto power and the greater the difference of their preferences, the more difficult innovative policymaking will become. This model – for all its oversimplification – is a very intuitive concept, which has been used widely to explain policy continuity and change in Germany (König and Bäuninger 2000; Merkel 2003; Strohmeier 2003).

However, the simplification has its drawbacks. Even by strongly crediting the inner cohesiveness of the veto players and combining it with electoral party competition, as Zohlnhöfer does in his analyses of both the Kohl and Schröder eras (Zohlnhöfer 2001, 2003b, 2003c, 2004b), the veto player model cannot explain innovative policy change in the absence of severe exogenous shocks (Trampusch 2005). Similarly, Blanke and Schmidt (2003, p. 235) find that the approach offers only “limited” explanatory value and suggest that “institutional and micro-political” dimensions be included in the analysis. Merkel (2003, p. 184) finds that the veto player model underestimates the “cooperative-federal institutions” in the Federal Republic (see also Schmidt 2003b). In other words, the veto player theory does not sufficiently take into account the cooperative nature of Germany’s political economy.

To better assess these claims, this paper refers to Peter Katzenstein’s concept of the semi-sovereign state, which has provided one of the most influential analytical accounts of former West Germany’s political system (for a critical appraisal see Green and Paterson 2005b) and still offers a compelling framework for the reunified Germany. The starting point of Katzenstein’s analysis is the question of how to “…account for the absence of large-scale policy change in the face of changes in the composition of government” (Katzenstein 1987, p. 4). Katzenstein describes the German political system as a complex institutional policymaking network that places substantial constraints on the policymaking capacities of the state, thereby “taming the power” of the German state.

Katzenstein’s approach shifts the focus away from formal or informal veto powers of individual agents towards the slightly more abstract concept of interfaces between these actors. Within the political system, Katzenstein identifies three of such key interfaces, or “institutional nodes,” namely political parties, federalism and para-public institutions.

> 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…Because it incorporates many of the institutions that also weaken it, West Germany’s state is best described as semisovereign. (Katzenstein 1987, pp. 81-82)

The attractiveness of Peter Katzenstein's concept of a semi-sovereign state lies in its ability to grasp the complex network structure of Germany's political economy by means of just three political interfaces. Green and Paterson (2005a, p. 5) find that, "Katzenstein's nodal concept captures perfectly how structure-agency debate in political science is played out in the German context." It is furthermore noteworthy that the components of a "bargaining democracy" (*Verhandlungsdemokratie*), another prominent description of Germany's complex policymaking structure going back to Lehmbruch (1976) and Lijphart (1984), are almost congruent with the "institutional nodes" of the semi-sovereign state.[2]

For an analytical framework to explain innovative policy change in the German semi-sovereign state, two components are required. First, the political economy must be suffering from an acute economic downturn, manifesting itself, for example, in a low or negative growth rate, a high and unsustainable fiscal deficit and/or high and rising unemployment. Quantitative investigations consensually identify economic crisis as a robust key determinant for structural reforms (see, for example, IMF 2004, Høj et al. 2006). While economic crisis – or the perception thereof – may indeed be a necessary condition for paradigmatic policy change, it is not a sufficient condition. Almost two decades of repeated economic downturn without significant structural changes in Germany illustrate the limitation of the so-called "crisis hypothesis."

Second, to capture the structure-agency determinants of structural reforms, the logic of the Katzenstein model will here be reversed. Katzenstein (1987) writes that, "political parties, and interlocking politics between different levels of government, and para-public institutions are the three nodes of such a tightly integrated policy network that major changes in policy

[2] Czada (2000) describes the three components of a "bargaining democracy" as "party concordance" (*Konkordanzdemokratie*), "corporatism" and "constitutionally interlocking politics" (*Politikverflechtung*). He finds that, "the singular position of the German case with numerous constitutional veto points, corporatist traditions and a rather weak party concordance is especially noteworthy" (p. 45) because it leads to a strong status quo bias.

stand little chance of success" (p. 35). In reverse, this implies that major or innovative policy changes are possible only if this "tightly integrated policy network" weakens; that is, if nodal points in the system lose their constraining character. To use Peter Katzenstein's concept of a semi-sovereign state as the analytical framework, it is necessary to review the nodal points as they were described in 1987 to see if and how these have changed to any significant extent. It should first be noted that the German electoral system (*eingeschränktes Verhältniswahlrecht*) has led to an increasingly fragmented party system. Two major parties, the CDU/CSU and the SPD still dominate the political agenda. As neither the CDU/CSU nor the SPD have ever been able to gain an absolute majority at the federal level, German governments have always been characterized by 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, Party of Democratic Socialism, renamed *Die Linke.PDS* in 2005) 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 party system is the role played by the two large parties as "catch-all parties." Their members encompass 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 organized labor, employer interests and other associations are important in both parties. In the CDU/CSU, the "Social Committees" (*Sozialausschüsse* or *Christlich-Demokratische Arbeiterschaft, CDA*, Christian Democratic Workers Association) represent the labor 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*, Working Group for Employee Issues) has traditionally been close to the trade unions, while the *Seeheimer Kreis* represents the modernizers in the party.

Second, Germany's constitution prescribes a strict vertical separation of power between federal and state levels. 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 republic (Art. 72, Para. 2 Basic Law). This provision has severe implications for policymaking at the federal level. Typically, the *Bundestag* should be able to overturn a veto by the *Bundesrat* (*einfache Gesetzgebung*, i.e., simple legislative procedure). In practice, however, 55-60 percent (Schindler 1999, p. 967) of legislation needs the approval of the *Bundesrat* (*zustimmungsbedürftige Gesetzgebung*, i.e., legislative procedure requiring assent) because it touches the competences or finances of the *Länder*. The *Länder* have thus gained considerable voice 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* (67.2 percent of the time from 1949-2000). Manow and Burkhart (2004) show that, while the number of legislative proposals actually vetoed by the *Bundesrat* is not significantly higher in divided government than in the case 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 non-incremental policy changes.

Third, Katzenstein emphasizes the importance of institutionalized, functional interest representation for policy outcomes in Germany. He lists a number of para-public institutions, including, the *Bundesverfassungsgericht*, the *Bundesbank*, the Federal Labor Office

(*Bundesagentur für Arbeit, BA*), the unemployment insurance agency and the Council of Economic Advisers (*Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung*). The institutions listed by Katzenstein can be divided into two groups: (quasi) veto-yielding independent institutions and tripartite governed institutions.

The *potential* impact of the first group of institutions, such as the federal constitutional court and the *Bundesbank*, on structural reform policies is significant. In reality, however, the impact of these institutions on the structural reform policy has been either unchanged – as in the case of the *Bundesbank* – or generally limited – as in the case of the constitutional court.[3] The loss of authority of some German institutions to the European Union (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.[4]

The corporatist institutions include a multitude of arrangements, by which social groups – trade unions[5], employer organizations[6] and welfare associations – are included in the political decision-making process. These social groups are represented in the governing bodies of

[3] The *Bundesbank* has lost its influence over monetary policy to the Economic and Monetary Union. However, the tough monetary stance of the *Bundesbank*, constraining the fiscal discretion of the German government, was replaced by the fiscal rules of the Stability and Growth Pact. The possibilities of fiscal expansion to make the bitter pill of structural reforms go down better remain limited. The *Bundesverfassungsgericht*, the federal constitutional court, has had very little impact on structural reform policies (Merkel & Petring 2007, pp. 139) and (as Helms 2003, p. 6, notes) has also lost some of its powers to the European Union.

[4] 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).

[5] *Deutscher Gewerkschaftsbund (DGB),* including *IG Metall, ÖTV* and *DAG* (now *Ver.di*)*, IG Bergbau, Chemie und Energie.*

[6] The most important employers organizations include*Bundesverband der deutschen Industrie (BDI), Bundesvereinigung der deutschen Arbeitgebervertretungen (BDA), Zentralverband des deutschen Handwerks (ZDH)* and *Deutsche Industrie- und Handelskammertag (DIHK).*

important para-statal institutions, such as the Federal Labor Office, the social security institutions, universities and the public broadcasters. These institutions differ somewhat from independent institutions, as their political influence is not primarily derived from constitutional independence or veto power, but their tripartite governance structure. However, these groups show one way in which trade unions and employer organizations can exert political influence.

This 'social partnership' between government, unions and employers that allows resolution of conflict through institutionalized cooperation has become the hallmark of German corporatism (Streeck 2005b). Beyond the tripartite-governed para-statal institutions, other institutions ensure a close linkage between the socio-economic and political sphere. For example, this linkage traditionally manifests itself between parties and social groups, such as the leadership overlaps of parties, trade unions and employer organizations (Hassel 2006b). The close institutional network also means, however, that the political influence of social groups on economic policy – particularly of employer organizations and trade unions has been very large. 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 and Hassel 2004, pp. 103). Thus, paradigmatic policy change can occur only if the social partners agree with one another or if their political influence is diminished.

In summary, using a revised version of the '"nodal concept," per Peter Katzenstein's 1987 study, the key determinants for economic policy may be described as follows: : (1) inner cohesion of the government remains an important aspect; (2) due to the increased competences of the federal level (the *Bund*) vis-à-vis the *Länder*, the *Bundesrat* gained weight in the federalism node and (3) Finally, rather than focusing on para-statal institutions in general, the last node is understood as the strength of corporatist influence on the political process. In the following analysis of continuity and change in Germany's economic policymaking between 1982 and 2005, the "crisis hypothesis," as well as these three institutional nodes – party competition, federalism and corporatism – will serve as the analytical framework.[7]

[7] Given the length of the timeframe 1982-2005, only central aspects of the different governments' economic policies will be taken into account. Reference will be made to more in-depth studies.

3. Economic Policy Continuity and Change 1982-2002

To analyze the period of economic policy continuity between 1982 and 2002, the epoch will be divided in three intervals. The analysis begins with the announcement of the "policy of change" by Helmut Kohl in 1982. 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 half of the Schröder government before the Agenda 2010 reforms were introduced.

3.1. Economic Policy in "Modell Deutschland"

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 had significantly dampened Germany's economic outlook. The crises and the lack of appropriate macroeconomic adjustment by the social-liberal government under Chancellor Helmut Schmidt led to steep rises in unemployment, combined with a huge expansion of welfare spending – around 10 percent per annum – during the 1970s (Zohlnhöfer 2007). When the CDU and the FDP assumed government control under Chancellor Helmut Kohl in 1982, many perceived the relatively high unemployment and slow growth as a domestically rooted problem that needed to be addressed by structural adjustment.

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 incrusted structures, towards more flexibility, initiative and competitiveness"[iv] (Kohl 1983, p. 11). Despite this Thatcherite rhetoric, no radical changes in the German political economy followed (Zohlnhöfer 2001). The value-added tax (VAT) was increased and spending for selected welfare programs was moderately reduced. In fact, the budget deficit reduction was financed mainly through the rebounding global economy of the 1980s; hence, the "consolidation was not really paid for by dismantling the welfare state in the 1980s" (Zohlnhöfer 2003a, p. 132). A greatly advertised income tax reform between 1986 and 1990 only marginally reduced the average tax burden. The "reform" of the legal shopping hours symbolizes the overall hesitant reform policy of the time: shops were allowed to remain open two more hours a week (Webber 1992, p. 158). The cautious content of the reform movement is well summarized as follows:

> [T]he government has done little or nothing to improve the working of the market ... preservation of inherited structures rather than fundamental reform has been and still is the dominant principle of economic policy in Germany. In this respect the Kohl government has proved to be as conservative as the preceding Schmidt government. (Hellwig et al. 1987, p. 140)

How can we explain this economic policy? The German economy recovered somewhat after the 1982 recession and grew at around 2 percent for most of the 1980s. Unemployment, however, remained stubbornly high at around 8 percent and continued to be a pressing problem for the government: consequently, more radical reforms of the labor market and the welfare institutions should have been easy to rationalize[8]

Even if only two of the nodal points, "party system" and "federalism" are taken into account, the lack of more radical policy change remains surprising. In fact, the conditions for fundamental economic reform seemed highly favorable. First, the Christian-liberal government had already won a majority of seats in the *Bundesrat* in 1972. Throughout the 1980s, CDU/CSU enjoyed very good ratings in the polls, marshalling considerable "electoral slack." Also the CDU/CSU's former 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

[8] Data: IMF (2008) *World Economic Outlook*.

Christian-democrats.[9] Both party politics and the party positions in the *Bundesrat* seem conducive to a more radical reform policy. This leaves the corporatist structures of the German economic model as the decisive variable for the reform inertia.

Wood (1997, 2001a) shows that the Kohl government's plan to liberalize the labor market in the mid-1980s – formerly, a stated priority of the Christian-democrat coalition (Zohlnhöfer 2001) – failed due to the resistance mounted by both the unions and the employer organizations. For example, both the unions and the employer associations rejected a coalition initiative to break the monopoly of DGB representatives in the work councils. More specifically, these two groups used their government influence, as wielded through the Social Committees of the CDU, to water down the legislative proposal. This maneuver, "can only be understood in the light of the characteristic patterns of organization and incentives in German industrial production" (Wood 1997, p. 24).

The Varieties of Capitalism literature develops a model of so-called "coordinated market economies," showing how firms use closely-knit corporatist networks and market regulations to their advantage. That is,, German firms exploit their "comparative institutional advantages," which allow them to coordinate their economic activity with other economic agents and specialize in skill-intensive, high-quality products and services. Having specialized in this "diversified quality production" (Hall and Soskice 2001), which made Germany an uncontested world-leader in the export of technical products such as luxury cars and machine tools, neither trade unions nor employer organizations were interested in altering the economic regime.

[9] In 1982 the liberal German Minister for Economic Affairs, Otto Graf Lambsdorff, published a "Concept to Overcome Low Growth and to Fight Unemployment" (Lambsdorff 1982), renouncing the Keynesian economic policy of the SPD and FDP coalition government and demanding structural reforms of the German economic system. This change in economic policy of the FDP triggered the end of the SPD/FDP coalition and the start of a Christian-liberal government after Helmut Kohl became Chancellor.

Union and employer interests were effectively transmitted both through their representation in para-public institutions, such as the Federal Labor Office, as well as through their influence in the party system. Labor-friendly Social Committees inside the CDU/CSU exerted substantial influence on the economic agenda of the CDU/CSU, for example, through their chairmen Norbert Blüm (who was simultaneously a member of the CDU's executive board and Minister of Labor from 1982 to 1998) and Heiner Geissler (who was Secretary General of the CDU). The interests of large- and medium-sized firms were effectively represented in the CDU/CSU by the *Mittelstands- und Wirtschaftsvereinigung* (Zohlnhöfer 2001, p. 42).

Thus, instead of the planned supply-side reform of the labor market, the Christian-liberal coalition promoted non-market mechanisms, helping to sustain *Modell Deutschland*. In what Streeck (2005a, p. 141) has called the "rise of welfare corporatism," the Kohl government implicitly entered into a contract with industry and unions, keeping any excess labor supply off the market by increasing the social budget. More specifically, the government stepped up its active labor market policies to fight unemployment, and these policies included continuing education measures and job training measures, employment-creation measures (*Arbeitsbeschaffungsmassnahmen*), structural adjustment measures and wage subsidies. Expenditures for these measures rose by 10-20 percent annually until the end of the 1980s (from €14.5 billion in 1985 to €25.1 billion in 1990).[10] Second, the government began encouraging early retirement schemes that helped firms adjust their labor demand despite highly regulated labor markets. Because companies massively applied these early retirement schemes to lay off workers (Trampusch 2005), the cost of these schemes rose from €95 million in 1985 to €546 million in 1989. By the late 1980s, approximate labor force participation for men between the ages of 60–64 reached only 30 percent, while it figured at 55 percent in the United Kingdom and 65 percent in Sweden (Wood 2001b, p. 387).

[10] Data: OECD, own calculations.

In summary, the central obstacle to more radical economic reforms in the 1980s was neither the party nor the federal system, but Germany's economic system and its corporatist structure. Beyond the budget consolidation and the "adjuration of market forces," no new economic concepts would have achieved consensus (Schmid 1991, p. 25). For the time being, *Modell Deutschland* seemed to work well for all parties involved: the unions, the employers and the government (cf. Kitschelt and Streeck 2004).

3.2. Economic policy after reunification

The fall of the Iron Curtain in 1989 and the surprisingly fast reunification of Germany in 1990 were bound to preoccupy German economic policy-makers. 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. East Germany *de facto* simply acceded to the West German constitution, which also meant that all socio-economic institutions and polices were automatically applied to the former East Germany.

Helmut Kohl's 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 effort has 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€1.4 trillion in 2005 (*Der Spiegel*, 22 August 2005). With huge increases in unemployment following closure of large sections of the planned economy's industries, active labor market policy and early retirement – which had worked well to stabilize unemployment rates in the 1980s in the former West Germany – became the preferred policy measure to maintain social peace in post-reunification Germany (Wood 2001b, p. 388). The cost of this measure peaked at €52.2 billion in 1992 for active labor market measures and at €18.6 billion in 1993 for early retirement measures.[11] Between 1990 and 1995, 57 percent of the former East German work force took part in active labor market programs (Zohlnhöfer 2003a, p. 141).

The loose fiscal policy and the 1:1 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.[12] The ensuing high inflationary pressure prompted the *Bundesban*k 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 adjustment pressure by the mid-1990s (Kitschelt 2001, p. 294). The pressure to lower the deficit was further amplified by the need to fulfill the Maastricht criteria of the European Monetary Union (EMU), a political priority of 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 peak in 1996 (Zohlnhöfer 2003a, p. 140).

In 1995-1996 the number of unemployed reached the 4-millionthreshold for the first time. In an attempt to reduce unemployment, the government agreed to enter into a tripartite agreement, "Alliance for Jobs" (*Bündnis für Arbeit*) with the unions and employer organizations in 1996.This move was patterned on the tripartite approach of the 1960s and 1970s, which was called *Konzertierte Aktion* (Concerted Action). A joint declaration of the government, employers' organizations and unions declared to cut unemployment by 50 percent by the end of the decade through wage moderation in exchange for employment guarantees. After several informal consultations, the "Alliance for Jobs" ended in April 1996

[11] Data: OECD.
[12] Data: IMF (2008) *World Economic Outlook*.

without an accord because no agreement on labor market liberalization could be reached. The "attempt to use the social capital accumulated in the associations for fundamental reforms"[v] (Streeck 2000, p. 56) had failed.

After the "Alliance for Jobs" came to an end, the Kohl government unilaterally introduced far-reaching economic policy reforms into the *Bundestag*. More specifically, the coalition amended the Protection against Dismissals Act, raising the threshold above which employment protection is applicable from five to ten employees. Further, the Act liberalized the use of fixed-term work contracts and cut sick pay to reduce non-wage labor costs (the issue over which the "Alliance for Jobs" had fallen apart). Last, the Act shifted the burden of finding a new job primarily onto the unemployed by tightening the criteria under which benefit recipients could refuse a job, and it reduced the content of active labor market policy (*Associated Press*, 7 November 1996).

How can we explain this economic policy? Growth and unemployment rates were not severely worse after the mid-1990s recession than they had been following the mid-1980s recession. However, in a reaction very dissimilar from that in the mid-1980s, the Kohl government turned away from the "social partnership" to implement reforms.

To understand the 1990s economic policy of the Kohl government, we have to take into account the gradual change of *Modell Deutschland* that took place in the shadow of reunification. European economic integration and market liberalization introduced concepts such as outsourcing, market capitalization, lean production, service economy, and mergers and acquisitions into the German economic landscape, thereby slowly changing established ownership and production structures (Schroeder and Silvia 2003, p. 254, cf. also Kinderman

2003, Beyer and Höpner 2003, 2004). With this, several of the key components of the "coordinated market economy" were starting to come undone.[13]

Particularly for smaller employers, Germany's system of "welfare corporatism" and collective wage agreements was becoming a major liability for international competitiveness. Rising unemployment during the post-reunification recession led to a steep rise in non-wage labor costs. Large firms were able to relocate labor-intensive production abroad or pass on the costs to their suppliers, but small- and medium-sized firms were indirectly forced to bear the cost. Consequently, many small- and medium-sized firms started leaving employer organizations (Thelen and van Wijnbergen 2003, Silvia and Schröder 2007). A conflict resulted between large and small firms inside employer organizations, which surfaced, for example, in the rhetorical attacks of the reform-minded chairman of the *BDI*, Hans-Olaf Henkel, against the *BDA* for its cooperative behavior (Streeck and Hassel 2004, pp. 106-112). Most importantly, however, firms and employer organizations increasingly viewed corporatist institutions as a burden rather than an asset for their business operations.

The changes to *Modell Deutschland*, which had primarily led to a weakening of the employer organizations (Lehmbruch 2000, p. 102), also strained the power of the unions. Increasing decentralization of wage bargaining – particularly in eastern Germany – contributed to a drastic decrease of unionization (Hassel 1999). Additionally, high unemployment and changing work environments (Schroeder 2003) caused union membership of the working population to fall from 33 percent in 1991 to about 22 percent in 2000 (Ebbinghaus 2002). Lower levels of unionization not only put substantial financial strain on the trade unions, but also undermined their legitimacy as worker representatives in the political sphere. Further, as described by Anke Hassel (2006a, 2006b), the disentanglement of trade unions and parties

[13] For example, Höpner and Krempel (2004) find that a slow erosion of the cross-shareholder system, the *Deutschland AG*, took place in the second half of the 1990s.

consequent diminished their ability to influence policies. For example, 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 late 1990s, none of the board members of German trade unions was simultaneously a political board member -- a configuration that had been common until the end-1980s.

Diverging interests between traditionalist and more reform-minded trade unions further weaken the political stand. Thus, internal association conflicts also accounted for the declining influence of the CDA, the trade union wing in the in the CDU (Zohnhöfer 2003a, p. 148/149). An early indicator of the union weakness in the 1990s was the quick, EU-induced privatization of several state-owned companies in the transport, postal service and telecommunication sector, which the unions were unable stop in spite of labor protests (on the postal service cf. *Süddeutsche Zeitung*, 29 June 1994).

All these developments severely weakened central components of Germany's corporatist structure. Even in the absence of a definitive measure marking their waning political influence, evidence supports the supposition that the wish or ability of the German social partners to uphold the status quo had faded. While a majority of employer organizations gave up their opposition to more far-reaching labor and welfare reforms, trade unions had lost too much of their political influence to stop the reform policies of the conservative government between 1996 and 1998.

However, this development did not open a window of opportunity for more drastic, third-order policy change because the CDU had lost its majority in the *Bundesrat* in 1991. Until 1995, the government had been able to cooperate with the opposition by appealing to "post-reunification consensus" (Zohlnhöfer 2003a, p. 139). Following the economic crisis, however, the opposition adopted a confrontational strategy. From 1995, the new chairman of the SPD, Oskar Lafontaine, who enjoyed the backing from the SPD-led *Länder*, started to use the *Bundesrat* as a veto tool to "undermine the Federal government's legislative program and profile the SPD" (Lees 2000, p. 90).

Many major reform projects, such as the attempt to consolidate the budget by more severe cuts in welfare spending or a major reform of the income tax system (*Steuerreform 1998/1999*), failed due to Bundesrat opposition (on the tax reform cf. *Associated Press*, September 25,1997). The FDP chairman, Wolfgang Gerhard, famously complained that "we are in government, but we are not in power!" (*Die Zeit*, 10 July 1997). Labor-market policy changes turned out to be less far-reaching than planned because the government had to drop issues that needed the consent of the upper house.

In summary, the Kohl government of the 1990s can be divided into two phases. During the first phase, a post-reunification consensus – helped by the domestic demand boom from 1990 to 1992 – between the major political parties, business and labor prevailed. In the second phase, the government embarked on limited employment policy changes. These policy changes were facilitated by the weakness of *Modell Deutschland*, which began to be vulnerable not only to outside influences, but also to the catalytic effects of reunification on the German welfare system. On the one hand, the reform-decelerating powers of the corporatist system were significantly weakened. On the other hand, however, the loss of a majority in the *Bundesrat* hindered the Christian-liberal government from enacting more far-reaching economic policy changes. In terms of Katzenstein's terminology, a shift in veto power occurred from the "corporatist node" to the "federalism node."

3.3. Economic policy under Schröder I

The election of the SPD and *Bündnis 90/Die Grünen* in 1998 marked the first time governing parties were completely replaced by opposition parties in the history of the Federal Republic. After 16 years of Helmut Kohl's government, which was accompanied by soaring unemployment and budget deficits, a break with unions and subsequent market-oriented reforms, the Christian-liberal government had lost the trust of the electorate. A growing "justice gap" (*Gerechtigkeitslücke*) feeling emerged, especially in eastern Germany, where more than 60 percent of the voters turned to the left political spectrum, namely the SPD or the PDS (Köcher 1998, p. 5). With the slogan "Social Justice and Innovation," the double act of Gerhard Schröder and Oskar Lafontaine, and a professionally organized election campaign, the SPD managed to draw votes both from the traditional social democratic as well as reform-oriented conservative voters (Stöss and Niedermayer 2000).

The Schröder government's first months were dominated by demand-side policies (Egle et al. 2003). The 1996 labor market reforms of the Kohl government were revoked, a move that the SPD had promised to carry out in the election campaign. The reintroduction of social security contributions for low income jobs (so-called "630-DM-jobs") and rules against pseudo self-employment (*Scheinselbstständigkeit*) were especially heavily criticized by employers (Egle 2006, p. 174, Rose 2003), who warned that the low-wage sector would be pushed back into illegality. Expenditures – especially for welfare measures – rose by 6.8 percent (Egle 2006, p. 163). 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 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" - *Bündnis für Arbeit, Ausbildung und Wettbewerbsfähigkeit*), the SPD hoped to revive the corporatist institutions that had been challenged during the last years of the Kohl government (Schroeder 2003, p. 12). In particular, the government tried to have unions agree to an employment-friendly policy. However, no compromise from the unions on wage moderation could be reached. Apart from the Job-AQTIV-Law (which stands for "activating, qualifying, training, investment, placement"), the results of the "Alliance for Jobs" were very limited (Heinze 2003, pp. 147-149, Reutter 2004, p. 105).

The second phase of the Schröder I government was heralded by the departure of Lafontaine as finance minister (Egle et al. 2006). Schröder replaced Lafontaine,chairman of the SPD with Hans Eichel, a fiscal conservative. The new finance minister implemented limited spending cuts in the welfare and pension system, which amounted to 1.5 percent of the budget in 2000 (cf. Zohlnhöfer 2003b, p. 198). However, after losing elections in several *Länder* (and subsequently the majority in the *Bundesrat*) and with disastrous results in European Parliament elections, further economic reforms were shelved (Schröder: "I've understood"). At this time, the pressure to reform was reduced considerably because 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" (*Politik der ruhigen Hand*), although the government did introduce some important pension and corporate income tax reforms in 2000/2001.[14] Despite the "incoherent policy profile" in social, fiscal and

[14] 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, pp. 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. This policy, which was expected to further undermine the *Deutschland AG* and with it *Modell Deutschland* (Egle 2006, p. 168), stands in sharp contrast to the attempts of Concerted Action in form of the "Alliance for Jobs." In many ways, the pension and tax reform can be understood as a pioneer of the Agenda 2010 policy.

employment matters, a traditional social democratic agenda dominated the SPD economic agenda until the end of the Schröder I phase (Zohlnhöfer 2004a, p. 125).

How can we explain this economic policy? The first years of the red-green coalition were marked by substantial intraparty conflict between modernizers and traditionalists, which can be understood in terms of the "catch-all party problem" of the analytical framework. In 1998 the SPD rode a wave of "new social democracy" that was sweeping through parts of Europe in the 1990s, namely the United Kingdom, France, Sweden, Portugal and Italy. But the vague concepts *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 and Henkes 2003, p. 73). The SPD program required a "concretion of the social democratic basic values liberty, equality and solidarity" (Meyer 2001, p. 13, and Egle 2006, p. 159).

The first year of the economic policy was steered by Finance Minister Lafontaine, a self-proclaimed left-Keynesian (Lafontaine 1999). Gerhard Schröder, on the other hand, is described as a pragmatic (Murswieck 2003, pp. 132-133, Egle 2006, p. 160). However, considering his direct political surrounding (Bodo Hombach, Frank-Walter Steinmeier, Alfred Tacke and Uwe-Karsten Heye) and the ties he made with German industry during his time as minister president of Lower Saxony, it is safe to assume that he belonged to the SPD's modernist camp. The balancing act between Schröder and Lafontaine, between the modernizer and the traditionalist, quickly broke down after the election and conflicts over the economic policy direction of the government intensified (Knaup et al. 1999). The quarrel lasted until March 1999, when Lafontaine, surprisingly, decided to step down from all his positions.

Schröder's subsequent attempts to introduce a general modernist policy failed, predominantly because of the resistance of his own party, which 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 and Schröder 1999), which can be understood as an attempt to reaffirm the chancellor's commitment to 'Third Way' concepts and as a rejection of Keynesian policies (Egle 2006, p. 168, Egle and Henkes, p. 77). Both the paper and the fiscal consolidation policy evoked strong resistance from the SPD labor committee AfA, trade unions and the parliamentary fraction (Egle and Henkes 2003, p. 78). The DGB, for example, called the Blair-Schröder paper a "historically blind defamation of the welfare state" (*Frankfurter Allgemeine Zeitung*, 10 July 1999, p. 10).

At the same time, as coalition partners, *Bündnis 90/Die Grünen* 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 program when they assumed government responsibility, apart from the eco-tax, which formed their "key project of an ecological-social modernization." (Egle 2003, p. 104) of the German economy, environmental – such as the nuclear power phase out – and societal issues dominated their political agenda. However, it is generally probably true that *Bündnis 90/Die Grünen* pushed the SPD in the direction of more innovative policy change.

First, in addition to the intraparty conflicts, the stronger integration of trade unions into the decision-making process increased the immobility of the government (Heinze 2003, p. 157). Instead of more innovative reforms, the "Alliance for Jobs" delivered a deadlock in labor-market policy. Streeck (2003) explains this result with the labor-friendly legislation implemented in the beginning of the term, for which the government had asked no concessions from the unions. Similarly, Ebbinghaus and Hassel (2000) find that tripartite negotiations have little chance of success if the social partners "have little to gain" (p. 60). In 2000, the "Alliance for Jobs" negotiations had practically come to an end, after which time members did not reconvene (Egle 2006, p. 177). Second, the role of *Bundesrat* in this period was limited, although it did block a more significant reduction of subsidies in the context of the tax reform (Egle 2006, p. 193). Even though the SPD lost its majority in the *Länder* just a year after coming to power, there were few drastic legislative projects that the CDU/CSU would have wanted to veto. In addition, the opposition was weakened by the CDU party donation scandal in 1999/2001.

In summary, the economic policy under Schröder I was characterized primarily by intraparty conflict (Egle 2006, p. 193). It was the "party politics" node that had accrued most weight, but the restoration of the corporatist structures, the situation in the *Bundesrat* and reduced reform pressure due to the cyclical improvement of the economic situation were not conducive to reforms either. It should be noted, however, that modernizers strengthened their position versus the traditionalists during this time (Seeleib-Kaiser 2003 pp. 353-354) and that policy changes, such as the pension and the corporate tax reform, could be considered as signs that the Schröder government was gaining more political room for maneuver.

4. Schröder II: The Agenda 2010

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 growth in 2002), and further unemployment rose quickly (from 7.8 percent in 2001 to 8.7 percent in 2002), forcing the government to end the "steady hand" policy.[15] A scandal in the Federal Labor Agency in spring 2002 served as an opportunity to reopen the reform debate: 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. Schröder reacted fast: first, he replaced the head of the agency with Florian Gerster, a modernizer, and implemented a corporate leadership structure; second, he created a "Commission for Modern Provision of Services in the Labor Market" (*Kommission für Moderne Dienstleistungen am Arbeitsmarkt*), known as the "Hartz Commission" after its chairman Peter Hartz, a former board member of the Volkswagen AG.

The Hartz Commission's primarily proposed to develop a more efficient BA by restructuring its job-placement program ("Job-Center"). The commission additionally proposed measures to increase pressure on the unemployed, encourage the integration of the labor 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 and social security insurance were not touched by the proposal (Schmid 2003, Jann and Schmid 2004, pp. 92-106).

These proposals notwithstanding, the SPD was threatened by the 2002 federal elections on the grounds of the country's poor economic performance. The CDU/CSU candidate, Bavarian

[15] Data: EUROSTAT and OECD respectively.

Minister President Edmund Stoiber, boasted better credentials on economic issues (Roth 2003, p. 52, Roth and Jung 2002). In the 2002 election campaign, Schröder promised to implement the reform proposals of the Hartz Commission "one-to-one," but the SPD's narrow victory was in fact attributed to the government's opposition to the US-led intervention in Iraq and Schröder's shirt-sleeved handling of the Elbe-floods. However, the "blood and flood effect" did not last long, and the SPD lost dramatically in the polls right from the beginning of its second term.

On 3 March 2003, Schröder announced the breakdown of the "Alliance for Jobs" and added that he intended to go ahead with a reform program, '\"…without the participation of interest groups" (*Der Tagesspiegel*, 4 March 2003). On 14 March, Schröder announced a new, broad reform package, the Agenda 2010. Beyond labor-market policy, the reform addressed taxes, higher education and job training, as well as the pension and health insurance system. The chancellor justified his radical reform policy with the need to make Germany's social market economy sustainable: "The alternative is obvious: Either we modernize our social market economy or we will be modernized by the untamed powers of the markets, which displace the social [dimension]"[vi] (Schröder 2003, also SPD 2003, p. 6).

The most innovative policy change took place in labor legislation, which adopted most of the Hartz Commission proposals (Jann and Schmid 2004). These proposals resulted in four new, separate labor market laws, known as Hartz I, II, III and IV. Employment protection was liberalized by the provision that dismissal protection applies 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* (Unemployment Compensation II) from January 2005 (known as Hartz IV). Legislation additionally reduced the period of primary unemployment assistance (now *Arbeitslosengeld I*

(Unemployment Compensation I) from 18 to 12 months (with an exemption for persons above the age of 55), 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 (*Vermittungsausschuss*). Finally, craft legislation was simplified by reducing the requirement of "master craftsmanship" (*Meisterzwang*) from 94 to 41 crafts. This brief summary of Agenda 2010 illustrates that the Hartzreforms are initially patterned after the 1996-1998 reforms of the Christian-liberal government, "which following the change of Government in 1998 were deemed 'anti-social' and repealed" (Ubber 2004, p. 136). The reforms then go well beyond the 1996-98 measures

Many SPD supporters were highly dissatisfied with the proposals. Harsh critique came from the unions and welfare associations, while employer associations reacted positive at first (Wessels 2006). However, as more details about the reform plans emerged, and it became clear that Agenda 2010 did not affect the wage-bargaining system, employer organizations became more critical, lamenting the persistent "reform deadlock." 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 particular, for the traditionalist camp inside the SPD and the PDS, Agenda 2010 heralded the end of the German welfare state (Adams 2003) and aroused fierce protest.

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 unions organized several mass demonstrations. Undoubtedly, the Hartz IV legislation helped the PDS (and the right-wing *Nationaldemokratische Partei Deutschlands*, NPD) win huge electoral gains in Saxony and Thuringia. In western Germany, a number of frustrated SPD politicians and union officials established the "Election Alternative for Jobs and Social Justice" (*Wahlalternative Arbeit und Sociale 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."

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 supply-side reforms (Egle 2005, p. 181). 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 (Hilmer and Müller-Hilmer 2006, pp. 189-190). 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 political office.

How can we explain this third-order economic policy change? Agenda 2010 seems to fundamentally contradict established knowledge that German policy change is incremental by nature. To see how the political economy had been transformed so as to facilitate drastic policy change, we again examine the three nodal points, "party system," "federalism" and "corporatism."

First, after the departure of Oskar Lafontaine, SPD modernizers had gradually gained an upper hand on economic policy matters. After the 2002 elections, federal ministry for labor (*Bundesministerium für Arbeit und Soziales*) and the ministry for economic affairs (*Bundesministerium für Wirtschaft und Technologie*) were merged. Walter Riester, a former vice-chairman of IG-Metall, was replaced by the declared modernizer and Minister President of North-Rhine Westphalia, Wolfgang Clement, to head the new "super ministry" for economic affairs and labor. The merger of the traditionalist ministry for labor with the business-friendly ministry for economic affairs is seen as an important factor supporting labor-market reforms.

The fact that Gerhard Schröder gradually adopted a "presidential" style of government (Murswieck 2003) also contributed to the weakening of the SPD's labor wing. This move made his policy more independent from opposition within his own party. Schröder'smedia skills allowed him to communicate, "directly with the electorate" (Helms 2003, p. 7/8). Schröder, well-known for his excellent sense of drama, proclaimed in the manner of another German reformer, Martin Luther ("Here I stand; I can do no other," *Der Spiegel*, 8 October 2004): "I stand here because there has to be change, because that is the appropriate reaction to the changed situation of our society"[vii] (Schröder 2003). At the same time, Schröder maintained very good direct contacts with both management and work councils in industry, which earned him the title, "comrade of the bosses" (*Genosse der Bosse*, cf. Niejahr 2002). This positioning allowed him to uphold close contact with the industry, while bypassing both employer and labor organizations. Second, the CDU/CSU-led *Länder*, which had gained a majority in the federal chamber in 2002, did not block Agenda 2010. Although the CDU/CSU could choose between a veto position and cooperation, its strategy was somewhat different than that of the SPD in the mid-1990s.That is, the party coalition decided to cooperate politically, while voicing "rhetorical critique" in public. The coalition called for restricting the independent wage-bargaining system, a demand that was clearly not going to be met by the government, for example. Zohlnhöfer (2004b, p. 397) credits the CDU and FDP with exerting a large influence on Agenda 2010, as these parties pushed the government towards more far-reaching reforms, e.g. the liberalization of mini-jobs and self-employment. Egle (2006, p. 155) speaks of an informal grand coalition between the red-green government and the CDU/CSU opposition majority in the *Bundesrat*.

Third and most significantly, the turning point in the economic policy of the red-green coalition came with the end of the "Alliance for Jobs" (cf. also Streeck 2003). The official end of the tripartite negotiations sent a strong signal of change, considering that Schröder simply could have maintained the *status quo* of an informal institution that had no longer been holding meetings. The SPD's backing away from the unions – especially from *IG Metall* and *ver.di* – thus marks a "break in the system" (Siegel 2006). Schröder himself describes Agenda 2010 as a direct consequence of the failed *Bündnis für Arbeit* (*Frankfurter Allgemeine Zeitung*, 23 September 2004, p. 3). Heinze (2003) finds that, "[i]n general the 'Alliance for Jobs' did not show the innovative consensus that was hoped for, rather the path-dependant inefficient corporatist institutions in Germany and only limited possibility for strategic shaping came to the forefront yet again"[viii] (p. 156).

Employer organizations did not want the tripartite system, and trade unions could not stand up for it. The creeping decentralization of wage bargaining and the loss of members were especially strong factors in forcing the trade unions to restructure and consolidate (Silvia 2008). The weakness of the trade unions was openly demonstrated during the 2003 *IG Metall* strike calling for a35-hour week for eastern German supplier 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 (Höpner 2003, p. 311/312). The view that tripartite negotiations were breaking down was growing:

> The organised, corporatist society is … in a state of growing disorganisation. Not only the normal working relationship breaks apart, the social-inclusive power of the association-state is falling apart…Big associations are by now perceived as a part of the problem by the public.[ix] (Heinze 2003, p. 142)

In fact, some go as far as to claim that the, "twilight of the Gods of the post-war corporatism" (Wessels 2006) has come and that the "century of corporatism" has ended (Streeck 2005b).

This proclamation may or may not be true. However, the relatively unobstructed implementation of Agenda 2010 at least seems to show a growing autonomy of the party system vis-à-vis the system of social and labor political associations (Trampusch 2004).

In summary, the red-green coalition made a remarkable shift in direction from its demand-side policies of 1998-1999 to supply-side reforms of 2003-2005. Agenda 2010 could be implemented because all three nodal points of the German political economy had lost their power to block this innovative policy change.

5. Conclusion and Outlook

An analysis of economic policy under Kohl and Schröder until 2002 shows that all three nodes of the German politico-economic system contributed to the apparent lack of innovative policy change. Somewhat stylized, 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 intraparty cohesion prevented innovative policy change under the Schröder I government (see Figure 1). The analysis of the German political economy under Schröder II with the introduction of Agenda 2010 demonstrates that the three nodal points traditionally cohering the political economy in Germany were fading: the SPD modernizers had assumed control of the economic policy agenda setting; the opposition, which dominated the *Bundesrat*, accommodated supply-side policy changes; the corporatist structures had been weakened too far to deter innovative policy change. In other words, the formerly semi-sovereign state, Germany, regained its economic policymaking capability to a considerable extent.

Figure 1

Nodes and innovative policy change of the German political system, 1982-2005

	Party politics	Federalism	Corporatism
Kohl in the 1980s	cohesive	accommodating	**strong**
Kohl after reunification	cohesive	**confrontational**	weakening
Schröder I	**non-cohesive**	accommodating	weakening
Schröder II	cohesive	accommodating	weakened

Arguably, 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. Globalization and Europeanization, new production systems, emergence of the service sector, and the catalyzing German reunification have led to a change in the preferences of firms, trade unions and the government that, together, maintained the German model of a coordinated market economy. Declining support for the German economic system and its cooperative institutions has substantially weakened its corresponding corporatist structures. These structures include both trade unions and employer organizations, but are also transmitted into party politics via the linkages between the parties and the associations.

We have seen how incremental change in societal, political and economic institutions can lead to non-incremental, that is to say third-order, policy change. In this context, innovative policy change is not to be misunderstood as the sum of numerous incremental institutional changes, i.e. “incremental change with transformative results,” as Streeck and Thelen (2005, p. 9) suggest. The analysis here presented shows how incremental change within a system of apparent institutional stability can reconfigure preferences and political constellations that, in turn, facilitate radical policy change. Similarly, Dyson (2005) suggests that incrementalism could “disguise” fundamental structural change by generating “tipping points” of innovative policy change.

The analysis in this essay does not mean to imply that the weakening of *Modell Deutschland* will necessarily lead to its complete erosion. The example of Sweden has shown that temporary crises of the cooperative institutions can be overcome (Thelen 1993). More successful German trade union action in recent years suggests that “there’s life in the old dinosaurs yet” (*The Economist*, February 16, 2006). Indeed, he Varieties of Capitalism literature questions whether the decline of Germany’s coordinated market economy is inevitable (cf. Deeg 2005, Busch 2005, Hancké et al. 2007). It is not unreasonable to conjecture that Agenda 2010 was only a historical coincidence and that Germany will return to a series of incremental policy changes.

In closing, it is worth noting that the grand coalition government of Chancellor Angela Merkel has so far avoided any paradigmatic policy changes. This outcome may seem surprising given that both coalition partners entered into the 2005 electoral race with a commitment to socio-economic change. The leadership of the SPD was committed to the Agenda 2010 reforms. The CDU/CSU pushed the debate to 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 advisors. Nevertheless, the grand coalition government has in fact reversed some components of the Agenda 2010 reforms (Zimmermann 2008), rather than pushing for further change.

This course in economic policy is easily explained by two factors. First, Germany's economy greatly improved over the past years, in part because of Agenda 2010 reforms (Zimmermann and Eichhorst 2008). 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 during the following two years.[16] The rebounding German economy was even referred to as a second German *Wirtschaftswunder* ("Germany's rebounding economy," *The Economist*, 4 January 2007). The need for more radical economic reforms is hard to communicate against this background.

Second, government cohesion is very low. The CDU/CSU's coalition partner, the SPD, underwent significant change after the departure of Gerhard Schröder. The emergence of the Left Party (*Die Linke*), a merger of the predominantly eastern German PDS and the WASG, is eroding the traditional party base of the social democrats. A quick succession of party leaders, from modernizers such as Franz Müntefering and Matthias Platzeck, to the more traditionalist

[16] Data: EUROSTAT Question: do you need a more specific reference?

Kurt Beck, has left the party in an ongoing dispute over its political direction. Generally speaking, traditionalists seem to be regaining more influence in the party, shifting its policy stance away from modernist towards more traditional social democracy. A reform such as Agenda 2010 seems almost impossible with the current line-up of SPD government leaders..

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[i] "One can do it this or this way. I am for this way."
[ii] „…mehr…als nur ein erster Schritt in die richtige Richtung."
[iii] „…wie in einem derart verflochtenen Regierungssystem überhaupt noch politische Entscheidungen möglich sind."
[iv] „weg von mehr Staat, hin zu mehr Markt; weg von kollektiven Lasten, hin zur persönlichen Leistung; weg von verkrusteten Strukturen, hin zu mehr Beweglichkeit, Eigeninitiative und verstärkter Wettbewerbsfähigkeit."
[v] „…Versuch, das in [dem] historisch gewachsenen Verbändewesen akkumulierte soziale Kapital zur Aushandlung grundlegender Reformen nutzbar zu machen …."
[vi] „Die Alternative ist eindeutig: Entweder wir modernisieren unsere soziale Marktwirtschaft oder wir werden modernisiert, und zwar von den ungebremsten Kräften des Marktes, die das Soziale beiseite drängen."
[vii] „Ich stehe doch hier, weil es Veränderung geben muss, weil das die angemessene Reaktion auf veränderte Zustände in unserer Gesellschaft ist."
[viii] „Insgesamt zeigt sich im ‚Bündnis für Arbeit' nicht der erhoffte innovative Konsens, eher treten wiederum durchaus pfadbestimmte Ineffizienzen korporatistischer Institutionen in Deutschland und nur geringer strategischer Gestaltungsmöglichkeiten in den Vordergrund."
[ix] „Die organisierte, korporatistisch verfasste Gesellschaft ist…in einen Zustand der wachsenden Desorganisation geraten. Nicht nur das Normalarbeitsverhältnis verfällt als anerkanntes Sozialmodell, die sozialintegrative Kraft des Verbändestaates zerbröselt… Großverbände werden inzwischen in der öffentlichen Meinung eher als ein Teil des Problems denn als Problemlösung gesehen."

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