

Challenging Neighbours: Rethinking German and Dutch economic institutions

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Abstract

CPB recently finished a study exploring economic institutions in Germany and the Netherlands entitled 'Challenging Neighbours: Rethinking German and Dutch Economic Institutions.' This article briefly describes the background and analytical framework of the study. Subsequently, it summarizes the main policy conclusions provided by the study.

Samenvatting

Het CPB heeft recent een vergelijkende studie afgerond naar de economische instituties in Duitsland en Nederland onder de titel 'Challenging Neighbours: Rethinking German and Dutch Economic Institutions.' Dit artikel beschrijft kort de achtergrond en het analytische kader van de studie. Vervolgens worden de belangrijkste beleidsopties die uit de studie voortvloeien samengevat.

In the beginning of September, CPB published 'Challenging Neighbours: Rethinking German and Dutch Economic Institutions.' Challenging Neighbours compares economic institutions in Germany and the Netherlands against the background of major social, demographic, technological, and international trends. The study explores the strengths and weaknesses of the Dutch 'polder model' or 'delta model' and the German 'social market economy.' In assessing these strengths and weaknesses, it frequently employs the United States and the United Kingdom as benchmarks. The analysis yields a number of policy options for both Germany and the Netherlands. After describing the background and motivation of the study, this article summarizes the most important policy conclusions of the study.

BACKGROUND AND MOTIVATION

Why focus on institutions?

Challenging Neighbours focuses on economic institutions, such as formal and informal rules, regulations and legislation. Examples are labor-market regulations, wage bargaining, rules on corporate governance, market regulation, etc. Compared to traditional fiscal and monetary policy, institutions are becoming an increasingly important determinant of economic performance. In particular,

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growing international interdependency has increased the importance of institutions as a major force in the process of international competition for mobile factors of production. This competition produces information about the institutions that work and do not work. By comparing the German and Dutch institutions, Challenging Neighbours allows policymakers in both countries to exploit this information, thereby learning from each other's successes and failures. Furthermore, it challenges them to address major trends through innovative policies.

Why Germany?

From a Dutch point of view, Germany is an obvious choice for a reference country because of the strong mutual links between the German and Dutch economies. Moreover, the main policy issues in both countries are quite similar, although specific solutions and approaches often differ.

Furthermore, by delving deeper into the institutions in the two countries, Challenging Neighbours scrutinizes the quickly shifting perceptions about the strengths and weaknesses of the German and Dutch economies. Until quite recently, the German 'social market economy' was generally praised as an economic model that combined economic vigor with solidarity and social consensus. At the present time, however, different words fill the air: structural rigidities, resistance to change, political deadlocks, high unemployment, and firms escaping high labor cost by investing abroad.

Whereas popular opinion on the social market economy thus shifted away from a superior form of capitalism towards an example of institutional rigidity, an opposite development took place in the common wisdom about the Dutch economy: 'Dutch disease' turned into the much envied 'polder model' or 'delta model.' In the 1970s and early 1980s, the Netherlands showed how *not* to deal with stagflation: an expanding welfare state financed by substantial natural gas revenues and a higher tax burden, failing social agreements between unions and employers' organizations (the social partners), surging unemployment and disability benefits, and widening fiscal deficits. At present, in contrast, many commentators praise the Dutch reforms in welfare state arrangements, wage moderation produced by cooperation between social partners, product market deregulation, and discipline in public spending, which allows a reduced fiscal deficit to be reconciled with a lower tax burden.

In arriving at a balanced view on the two economies, one should keep in mind that unification strongly affected the German economy in the 1990s. Unification would have presented a major challenge to any economy. After a comparable shock, many countries would have been in worse shape than Germany is in at the moment.

How?

In exploring how institutions affect economic performance, the study emphasizes that institutional design involves trading off various objectives. The analytical framework

(see box, “The analytical framework: Coordination and trade-offs” on next page) of the study starts from four major market failures that require coordination (the so-called coordination issues). Subsequently, it identifies four mechanisms to coordinate decisions: competition, control, cooperative exchange, and common values and norms. An analysis of the strengths and weaknesses of the coordination mechanisms yields four fundamental trade-offs: flexibility versus commitment, incentives versus solidarity, diversity versus scale (or scope), and experimentation versus certainty. The trade-offs indicate that different institutional orders are feasible, each featuring their own strengths and weaknesses. National institutions determine which side of a trade-off features more prominently in a specific country. Since a country’s position on each trade-off affects economic performance, the trade-offs link institutions to performance.

These links depend also on social, technological and economic conditions affecting the environment in which institutions operate. Trends changing the environment may shift these conditions and may thus require institutional adjustment. Challenging Neighbours focuses on demographic, social, technological and international economic trends. Aging is a major demographic trend. Important social trends include more heterogeneous societies, individualization and increased environmental concern. The most relevant technological trends involve the diffusion of information technology, which makes technology more easily marketable, and the emergence of the entrepreneurial firm in which learning and incremental innovation are the crucial activities. Several trends, including internationalization, liberalization, deregulation, and the emergence of regions in Asia and Eastern Europe, are reshaping the international economy.

POLICY OPTIONS

The socioeconomic order: looking for new combinations

Trends call for new combinations of institutions at different levels within the socioeconomic and political order. To illustrate, social and technological trends demand decentralization in industrial relations. This enables differentiation between sectors and companies to arrive at tailor-made and flexible solutions meeting the trends towards heterogeneity, individualization and market-oriented technologies.

After a long period of deadlock and social turmoil in the 1970s and early 1980s, the severity of the crisis of the welfare state forced the Netherlands to initiate a process of institutional innovation in the 1980s. New combinations in the Dutch socioeconomic order entailed a shift towards more advisory relationships. In particular, agreements between the social partners at the national level no longer specify detailed outcomes, but identify common policy objectives, specify general guidelines and define boundary conditions. This facilitates the commitment to common goals. At the same time, the responsibilities of the govern-

The analytical framework: Coordination and trade-offs

Coordination issues identify four main areas that require coordination:

- market power results from economies of scale or collusion,
- externalities are interdependencies outside the price system,
- specificity concerns investment in relationship-specific assets,
- risk sharing deals with fundamental uncertainty.

Coordination mechanisms define the type of human interaction:

- competition entails rivalry between agents striving for something that not all can obtain,
- control entails the power of an agent to take decisions and impose these on others,
- common values and norms pertain to congruent sets of preferences within a group of economic agents,
- cooperative exchange involves bargained consultation and cooperation between a limited number of otherwise independent agents with different preferences.

Coordination issue	Relevant trade-off
market power	diversity versus scale or scope
externalities	experimentation versus certainty
specificity	flexibility versus commitment
risk sharing	incentives versus solidarity

ment and the social partners (at different levels) were clarified and separated. Once a common goal, like the restoration of profitability and employment, had been identified, this facilitated a joint approach to address economic and social challenges. At the sectoral or firm level, for example, employers and unions apply their specific policy instruments to implement the general agreements.

To a certain degree, the German position after unification resembles the Dutch position after stagflation in the early 1980s. Both shocks required medium-term moderation of real disposable incomes. However, socioeconomic institutions in both countries failed to internalize the positive external effects of wage moderation. Moreover, expectations adjust slowly to new circumstances. Accordingly, a vicious circle resulted of rising labor costs, declining employment, rising tax burdens and widening government budget deficits.

In Germany, the strong political checks and balances (i.e. the formal separation of government and the associations of labor and capital, the juridical foundation of the socioeconomic order, interlocking federalist relationships and the opposition majority in the Bundesrat) hamper attempts to establish support for reform. Indeed, Germany faces the challenge to translate the strong checks and balances into a more flexible socioeconomic and political order.

Is the revitalized Dutch model of any help in creating a more flexible socioeconomic order in Germany? Although the Dutch model is often believed to fit only a relatively small homogeneous society like the Netherlands, some of its strong elements may be applied in Germany at the level of individual Länder. Accordingly, less coordination would occur at the national level but more bargained consultation would take place at the regional level. This would not only allow flexibility to accommodate diverse regional circumstances and to experiment at the regional level, but also help to build commitment within Länder.

Social security and the labor market

Netherlands: better governance of social security

The Netherlands is introducing various checks and balances in the governance structure of social insurance in order to enhance the accountability of the social insurance administration. In line with the situation in Germany, the roles, objectives, and responsibilities of the various players have been clarified. Also in social assistance is the Netherlands moving in the direction of the German system, by delegating more responsibility to the decentralized level. To reap the benefits of this reform, plans to increase the budget responsibility of municipalities should proceed.

The relatively high Dutch replacement rates for social disability continue to make the disability scheme vulnerable to moral hazard. In stemming the inflow into disability schemes, the Netherlands can benefit from the tight claim assessment procedures in Germany, which are based on control and strict regulations.

Netherlands: better conditions for apprenticeships

To encourage Dutch firms to invest more in portable training, two main lessons from the German apprenticeship system are relevant. First, co-financing of workers should be increased, thereby boosting the returns of the firm on apprenticeship training. Collective labor agreements may have to provide more flexibility to adjust apprenticeship wages to training costs and the situation in the labor market. The other lesson from Germany is that the apprenticeship system should be diverse enough to be attractive for a wide ability range.

Germany: more labor market flexibility

A well-functioning labor market with a high level of employment is a prerequisite for generous social insurance. Moreover, participation in the labor market should be the preferred route for protecting people against income loss. In this connection, wage moderation yields a double dividend. First, it enhances employment -- the financial base of the welfare state. Second, it reduces spending on social benefits by cutting both the value and the number of benefits.

The German system of collective bargaining is not conducive to wage moderation. In particular, sectoral

collective bargaining is less strongly influenced by consensus building at a centralized level than it is in the Netherlands. Rather, by giving leading sectors a large autonomy in collective bargaining, it tends to induce leapfrogging. In line with the suggestions with respect to the socioeconomic order, part of the centralized coordination in Germany could occur at the regional rather than the national level because the building of consensus and commitment tends to be easier at a lower level. In order to ensure that regional agents internalize the external effects of their bargain on the unemployment level, the regional level may have to assume a larger budget responsibility for unemployment insurance. Bargaining consultation at the central -- regional -- level could provide general guidelines, while delegating specific issues to a more decentralized level to meet the need for more differentiation and flexibility.

To improve overall employment, also a flexible labor market can make an important contribution. A labor market with low entry barriers to outsiders constitutes an important insurance mechanism against the risk of income loss. In this connection, more liberal regulations with respect to the use of flexible contracts in Germany could increase the access of unskilled workers to the labor market. Moreover, flexible contracts may meet the more heterogeneous needs of employers and workers.

Germany's emphasis on control and regulations in social security implies that Germany may need to employ fewer financial incentives to stem moral hazard than the Netherlands does. Nevertheless, the market-oriented reforms in disability and sickness insurance may provide a source of inspiration for Germany. In particular, privatizing the sickness scheme, as in the Netherlands, would imply that employers bear the full cost burden of the effect of generous extra-statutory provisions on the sickness rate. This would encourage employers to reduce these supplementary provisions.

Unfinished agenda for both countries

Technological and organizational developments increasingly put at risk vulnerable individuals with few marketable skills. Social benefits were originally intended to primarily relieve liquidity constraints by carrying people over relatively short unemployment spells. At the present time, however, structural unemployment and dependency require more active policies with conditional and in-kind benefits (e.g. training and other investments in human capital) to avoid social exclusion and maintain human capital. Wage subsidies or vouchers for the long-term unemployed can be used as a particular form of in-kind benefits aimed at stimulating demand for the low skilled. This demand may be stimulated also by deregulating sheltered sectors. Indeed, more flexible labor and commodity markets help to increase the access of vulnerable groups to work.

A shift towards more active labor-market policies involving conditional and in-kind benefits calls for tailor-made solutions implemented by a decentralized benefit



administration that exploits its information advantage about individual circumstances. Accordingly, social security administrations should be transformed from hierarchical bureaucratic organizations to more decentralized, entrepreneurial and customer-oriented bodies with their own budget responsibility. This requires the delegation of decisionmaking and budget responsibility to more decentralized levels.

Pensions

The rapid aging of the population over the next four decades poses serious challenges to pension systems. At the same time, various non-demographic trends (including financial innovation, international integration, technological change, individualization, and a more heterogeneous population with diverse needs) call for pension reform.

Netherlands: lower aspiration levels

The Dutch pension system contributes to high marginal and average tax wedges, thereby distorting labor supply. Moving away from final-pay to average-pay occupational schemes would narrow these wedges by tightening the link between premiums and benefits. Increasing the possibilities for firms to opt out of industry-wide pension funds is consistent with the trend towards more heterogeneous preferences, which requires more diversity. Moreover, more opt-out possibilities would increase competitive pressures on pension funds to improve their performance. To address these trends and at the same time maintain some intergenerational risksharing, firms could be required to participate in industry-wide pension funds only for pension benefits with lower aspiration levels.

Germany: smaller first pillar

The German welfare state is especially vulnerable to aging because a large part of public transfers accrues to the elderly. Germany may therefore want to gradually reduce PAYG benefits collected by those earning higher incomes. This would yield a better balanced portfolio between funded and PAYG schemes, as workers with middle- and higher incomes would substitute private (funded) pensions for public PAYG benefits.

The current system of book reserves for occupational pensions discourages the development of modern financial markets and inhibits the efficient allocation of capital. Moreover, it prevents pension saving from benefiting from higher returns and more diversification. To address these drawbacks of book reserves, the government should remove the tax obstacles against setting up independent pension funds.

Occupational pensions in Germany stress commitment at the expense of flexibility. To address various trends that demand more flexibility in the German labor market, the vesting period for pension benefits could be shortened. Furthermore, increased portability of pension rights would facilitate labor mobility.

Unfinished agenda for both countries

The third, voluntary, pillar of pension insurance, which can cater to individual preferences, is quite small in both countries because the mandatory, collective level of pension insurance is high. As tastes have become more heterogeneous and the mandatory aspiration levels have increased in after-tax terms, many workers are likely to have become overinsured. Diversity and personal responsibility in pension insurance could be enhanced by reducing high compulsory levels of collective pensions, thereby leaving more room for individual provisions. These latter provisions could insure individuals against not only old-age risk but also other human capital risks, such as unemployment and obsolescence of human capital.

The effective retirement age is quite low in both countries. To facilitate efficient decision making by workers with diverse needs and preferences, pension systems should confront potential retirees and their employers with the social costs of retirement. In other words, early and delayed retirement benefits should be more actuarially fair.

Various routes for withdrawing from the labor force are substitutes. Thus, in confronting employers and workers with the social costs of early retirement, governments should pursue a comprehensive approach. Various conditional social security benefits, such as unemployment and disability benefits, are subject to moral hazard. As the work force ages, these moral hazard problems become more serious because older workers are subject to higher disability and unemployment risk. These considerations increase the need to reform social insurance along the lines outlined above. Moreover, age-related pay schemes may have to be reconsidered so that wages can be better adjusted to individual productivity levels. Also this may require modification of social security schemes. For example, occupational pension systems and unemployment insurance schemes that link benefits to final pay, discourage gradual retirement through occupational downgrading with lower rates of pay.

Indexing the statutory retirement age to life expectancy is the most natural way to insure society against a longer average life of its citizens so that people spend part of their longer life in work and part in retirement. A higher retirement age implies that the human capital embodied in the elderly is used more intensively, thereby raising the return on human capital formation.

Corporate governance

Germany: replace the co-determined supervisory board

In the same way as German interlocking politics (*Politikverflechtung*) in intergovernmental relationships, interlocking checks and balances in corporate governance limit flexibility. The German supervisory board constitutes the nexus of all checks and balances between the different stakeholders in the company. This combination of the interests of several stakeholders in a single institutional body complicates decision making, tends to narrow the discussion to rather general observations, and

hampers exchange of information because of a fear of loss of confidentiality. A stronger separation of responsibilities among the various actors and institutional bodies, such as the works council, may still provide the checks and balances that are required to sustain commitment, while at the same time enhancing incentives and flexibility.

Two institutional adjustments seem desirable. First, replacing the co-determined supervisory board and more intensively using supervisory board subcommittees. Second, restricting the voting power of banks, conform current policy proposals, would help disentangle interlocking checks and balances.

The Netherlands: leave co-option

To enhance the efficacy of Dutch corporate governance in safeguarding the quality of both the management board and the supervisory board, the influence of shareholders on the supervisory board should increase. A lesson from the German model is to leave co-option and to allow a (substantial) majority of votes in the general meeting of shareholders to replace the supervisory board. These reforms would give the Dutch corporate governance institutions a relatively strong central position on the trade-off between commitment and flexibility; this system would suffer neither from the inefficacy of a co-determined board (as in Germany), nor from a short-term orientation and frequent hostile takeover practices (as in the United States).

Science and technology policy

Germany: more differentiation and flexibility in higher education

Strengthening subsidiarity would promote differentiation and flexibility in German higher education. Diminishing national coordination may also increase experimentation at the decentralized level to reduce the length of studies and to curtail the high teaching load. Proper financial incentives may support this experimentation by intensifying competition between Länder.

Netherlands: more flexibility of research centers

The German Max Planck Gesellschaft not only performs high-quality basic research but also explores new scientific areas. In thus combining quality and flexibility, it provides an interesting case for current Dutch policy initiatives aimed at concentrating basic research institutes in separate and flexible organizations.

Germany applies rather strong financial incentives to enhance flexibility of its Blue List institutes, which have to compete with universities for funding. This policy appears rather effective in promoting flexibility. Accordingly, Germany may want to apply a similar policy to its large research institutes, which at present run the risk of becoming locked in technologies of the past. If the aim is to enhance flexibility, also the Netherlands may want to raise

the share of peer review finance and contract finance in total financing of its large research centers.

Regulation and competition policy

Developments in the Anglo-Saxon countries, the creation of an internal European market, technological developments, and modern regulation theory have stimulated reform of regulation and competition policy in both countries. The new Dutch Competition Act is modelled after the corresponding German and European provisions. Just as in Germany, the new Dutch competition authority will be independent from the political authorities with the primary aim to safeguard competition. The Netherlands may also want to consider instituting a committee of independent experts who regularly report on the state of competition. This is in analogy of the German Monopolies Commission.

Unfinished agenda for both countries

Independence is desirable not only for the competition authority but also for regulators. Unlike the United Kingdom and the United States, however, both Germany and the Netherlands lack a complete network of independent regulators. Following the examples of the Anglo-Saxon countries, (future) regulators not only should be independent from the ministries that are currently responsible for regulation, but also should be placed under the competition authority. This allows knowledge and expertise to be shared. Most importantly, it mitigates the risk of regulatory capture.

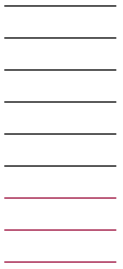
As regards regulation policy, Germany and the Netherlands are currently in the process of implementing European Union directives aimed at liberalizing sectors that used to have a natural monopoly nature. In telecommunications, for example, more network competition and a less restrictive concessions policy will intensify competition. Germany is lagging somewhat behind in this respect, as German Telecom is one of the few monopolistic operators in Europe that controls the cable TV network. With respect to the liberalization of postal services, however, Germany is ahead of the Netherlands. In public transport, competition is still practically nonexistent in both countries and will require additional government actions. Furthermore, at the more decentralized government levels, privatization opportunities should be encouraged, for example in waste management and public housing.

Electricity and gas markets

These energy sectors illustrate the importance of introducing competition as a way to enhance efficiency in sectors that were previously considered natural monopolies requiring heavy government intervention.

The electricity market: more checks and balances

Whether current reform proposals will actually be effective in stimulating competition is subject to some doubts. To



further strengthen competition, Germany may want to introduce regulated third-party access, separate the grids, and allow more contract freedom.

In addition to separating the grid, converting the four existing regional generators into independent production companies would be the most effective way to introduce genuine competition on the Dutch domestic market. The exploitation of economies of scale and strengthening the competitive position of Dutch generators on the European market might constitute arguments for merging the relatively small Dutch generators into a single large-scale production facility. To secure effective competition on the domestic market, this latter option would require not only separation of the grid but also independent ownership relations and a powerful Supervisory Authority.

The natural gas market

Also in the gas market, there is a need to separate the natural monopoly from competitive activities and to establish independent supervision. Leaving the grid in the hands of parties that have interests also in the sale of gas runs the risk of inhibiting genuine competition.

As a country without major natural gas resources, Germany has a strong interest in strengthening free trade and competition in the natural gas market in order to secure reliable gas supply at low prices. Nevertheless, Germany has taken only modest steps to liberalize the gas market. Accordingly, additional steps, such as introducing regulated instead of negotiated third party access and unbundling of the networks, are called for. In view of the large size of the German market, unilateral German steps may facilitate similar steps on a European level.

The Netherlands is one of the few European countries with large natural gas reserves. In contrast to Germany, therefore, the Netherlands faces a trade-off between competition and the rents of natural gas, which largely flow to the central government. Whereas the Dutch government accepts lower rents as a result of the liberalization of the internal gas market, it is not prepared to walk in front, thereby losing even more (domestic) revenues for the sake of (international) competition. Given this position, room for further unilateral liberalization is very limited.

Health care

Health care systems in both countries are quite similar and have moved in the same direction in recent years. The main failure in the health care market that both countries have not tackled so far is moral hazard by the provider of health care. To alleviate this problem, the scope for introducing more managed competition in health care should be explored. Managed competition deals with information asymmetries, adverse selection, and moral hazard by creating certain

institutions. One important element is to allow insurance plans to exclude inefficient providers and select efficient ones. This facilitates integration of the financing and delivery of health care in so-called health plans. Another element is to allow the (integrated) providers to compete for customers. A final element is the creation of a sponsor. The sponsor acts as the purchasing agent for a pre-selected pool of customers. Moreover, it makes the market more transparent by providing information about the health plans and screening the risk features of the customers. Collecting information on ex-ante risk allows the sponsor to compensate the competing plans for differences in ex-ante risks. Accordingly, as various health plan providers try to gain a competitive advantage, they can focus on providing better health care rather than on risk selection.

Introducing more managed competition features some drawbacks. In particular, it results in more diversity in service levels, in other words inequality. In view of the strong preferences for equal treatment in Germany and the Netherlands, we suggest to start with a limited experiment, also because managed competition entails sailing into untested waters. In the Netherlands, such an experiment could focus on private insurance.

CHALLENGING NEIGHBOURS: A LEARNING PROCESS OF ITS OWN

The research for Challenging Neighbours started as an exercise in applied institutional economics. An exciting exercise, which proved to be more difficult and extensive than anticipated at the beginning. A major strength of this study is that it provides a strong theoretical framework to understand the trade-offs that society faces in institutional design. The framework helps also to explore how future trends impact the positions of the trade-offs. The qualitative analytical method complements quantitative benchmarking studies, such as the recent competitiveness reports by the Dutch Ministry of Economic Affairs.

In accordance with the focus of the study on major trade-offs in institutional design, policy conclusions should be regarded primarily as food for thought rather than precise policy prescriptions. Indeed, the complexity of the issues precludes simple solutions.

Challenging Neighbours constitutes the background report for a conference on Standort Germany and Standort the Netherlands in Düsseldorf on September 10 and 11. CPB looks forward to the opinion of researchers and policy makers on the issues and highly welcomes feedback on the contents of the book. ■

Reference

CPB Netherlands Bureau for Economic Policy Analysis (1997), *Challenging Neighbours: Rethinking German and Dutch economic institutions*, Springer Verlag, Berlin - Heidelberg, ISBN 3-540-63501-7.