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The Political Economy of Germany's 'Agenda 2010' Reforms: Insights from an Augmented Veto Player Model

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Abstract

Germany's 'Agenda 2010' labour and welfare reforms contradict conventional wisdom that its political economy with many veto players disallows paradigmatic structural change. To address this puzzle, this paper presents an augmented version of the Veto Player Model. Introducing veto clusters to the model allows to map Germany's complex political economy structure with many interlocking and overlapping actors and institutions, and to better understand the dynamics of changing policy preferences. The paper shows that three veto cluster – corporatist interests, the federal governance structure and the lack of cohesion within the federal government – alternately blocked reform in Germany between 1983 and 2002. Only in 2003, when the blocking power of all these constraints waned, was it possible for the federal government to implement far-reaching socio-economic reforms.

Keywords: Agenda 2010; Germany; Augmented Veto Player Model

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1. Introduction

By the early 2000s the resilience of Germany to structural change had become proverbial. In 1982 and in view of worsening economic prospects, Helmut Kohl had announced a 'policy of change' with the objective of 'reducing the state to its core competences'.¹ However, in spite of a continuous reform debate, no paradigmatic reform of the welfare system and labour market followed. With policy changes apparently impossible even in times of low economic growth and high unemployment, Germany became known as the 'the blocked republic'.² Scholars have argued that Germany's complex politico-economic structures obstruct economic reform policy (Kitschelt and Streeck, 2004; Welsh, 2005). That is, a very large number of actors and institutions exert their authority in the process of policy formulation and legislation, effectively preventing a majority-backed government to put into practice any paradigmatic policy change. Katzenstein (1987, 351) finds that, 'within the constraints and opportunities that characterise the Federal Republic, incremental policy change [...] is a politically logical choice'.

The 'Agenda 2010' reforms stands in sharp contrast to this conventional wisdom about Germany. Announced by Gerhard Schröder in 2003, this policy initiative intended to reform the institutional structure of the German labour market, the

¹ Government Declaration of the Federal Chancellor to the German Bundestag, 4 May 1983, Bonn, translation.

² Die blockierte Republik, Der Spiegel, 21 September 2002.

social security system, the tax system, and the research and education system to address ‘the challenges [...] of the 21st century.’ (SPD, 2003, 6, original in German). The legislative changes subsequently implemented are commonly held to be ‘the most ambitious seen in post-war Germany’, resulting in a significant re-calibration of the German socio-economic system.³ Schröder’s successor, Angela Merkel, lauded the reform policies as ‘historical’.⁴ This assessment is broadly shared in academia (Egle and Henkes, 2003; Trampusch, 2005; Schmid, 2006; Merkel et al., 2008; Burda and Seele, 2020).⁵ Structural reforms can be defined as enacted government policies intended to change for the better the institutional structure governing a policy sector. While there were instances of change to welfare and labour market regulation that broadly fall into this definition before and after the Agenda reforms, these remain isolated and limited in scope. The Agenda 2010 reforms constitute the only successful, wider overhaul of the German socio-economic system since the Second World War.

Given that this type of structural reforms has been on the policy agenda of Germany since the early 1980s, the implementation of the Agenda 2010 reforms presents an empirical puzzle. Why was it possible for Germany to deviate from ‘the logic of incremental change’ and introduce more paradigmatic, structural reforms in the early 2000s? Why was the first major reform of the German socio-economic model undertaken by the second Schröder government coalition and not by any of the governments that preceded it?

To address these questions, this paper puts forward an augmented veto player framework for the analysis of Germany’s political economy (Section 2). It argues that the standard veto player framework is quickly overburdened if it attempts to factor in all important actors and institutional elements of the German political

³ The Economist, 18 December 2003.

⁴ Frankfurter Allgemeine Zeitung, 22 August 2006.

⁵ Some have disputed the political and economic significance of the reform agenda (Zohlnhöfer, 2004; Kemmerling and Bruttel, 2006; Dustmann et al., 2014).

economy. Rather, it is suggested to break down the complex system of veto players into a number of sub-systems or clusters, each of which can prevent policy change in Germany. It subsequently identifies three pivotal veto clusters in Germany, namely the veto points within the federal government, in the federal legislative system and in the system of corporatist interest representation.

In applying the augmented veto player framework, the paper can show why the Schröder government of the early 2000s could overcome the 'blocked republic' and introduce more paradigmatic structural change. In Section 3, the framework is used to analyse the causes for reform inertia between 1982 and 2002, despite varying political constellations and changes in the country's economic structure. Section 4 will show how the framework helps to understand the adoption of the Agenda 2010 reforms. The reforms were possible because the three veto clusters in Germany's political economy had lost their binding constraints. First, the SPD modernisers had assumed control of the economic policy agenda setting. Second, the opposition, which dominated the *Bundesrat*, accommodated supply-side policy changes. And third, the corporatist structures had been weakened too far to deter innovative policy change. The paper makes use of a broad spectrum of sources, including semi-structured and narrative interviews (conducted between 2006 and 2008 with German policy-makers, government officials and journalists), newspaper articles, official documents, macroeconomic data as well as references to the literature.

2. The analytical framework

Germany's post-war political system was designed to avoid instability and abuse of power by delegating political power to many political and economic actors. Indeed, the list of policy-constraining actors is long. Within the government, the coalition parties as well as the relatively independent government bureaucracy (*Ressortprinzip*) have significant political influence. Outside the government, the German federal system limits the policy-making capacity of the federal government *vis-à-vis* the *Länder*, the federal states. When the opposition parties win elections in

a majority of the *Länder*, the government loses control of the *Bundesrat*, the veto-yielding second, federal chamber of parliament. Finally, other outside actors, such as the federal supreme court (*Bundesverfassungsgericht*), the European Union (EU) as well as a multitude of well-organised ‘special interest groups’ – many of which have privileged access to the policy-making process – also exert constraining political influence. This has raised the question, ‘how political decisions in such an interlocking governmental system are at all possible’ (Holtmann and Voelzkow, 2000, 15, original in German).

The Veto Player Model and veto clusters

Arguably, the dominant analytical framework to analyse German policy continuity and change over the past decade has been the veto player framework, following the ‘Veto Player Model’ developed by Tsebelis (1995, 2002). In spite of criticism from both historical and rational choice institutionalists (Wagschal, 1999; Schmidt, 2003b), the intuitive simplicity of the framework has preserved its popularity among researchers studying German politics (Bawn, 1999; Zohlnhöfer, 2003; Busemeyer, 2005; Saalfeld, 2005; Strohmeier, 2006; Blank, 2012; Brouard and Hönnige, 2017, and others).

The Veto Player Model offers an appealing framework to analyse the highly complex German political system. The model translates the classic analysis of institutional structures in political science into a relatively simple agent-based model, focussing on ‘individual or collective actor[s] whose agreement (by majority rule for collective actors) is required for a change in policy’ (Tsebelis, 1995, 301). It thus breaks down complex political structures to one simple question: which agents are able and willing to prevent a departure from a policy status quo? More specifically, the veto player framework assesses whether a policy proposal put forward by the agenda setter – typically the incumbent head of government – will

meet with the approval or rejection of the so-called 'veto players'.⁶ With their veto power, veto players can prevent a departure from a policy status quo if this policy change does not meet their policy preferences. Thus, the viable policy alternatives are delimited by a 'winset', defined by the individual policy preferences or policy positions of the veto players. The smaller the winset for policy change, the lower the probability that the status quo will change.

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

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

⁶ Veto players are either 'institutional veto players', whose political powers are enshrined in the constitution, or 'partisan veto players', whose political power emerges from the constitutional reality.

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

This approach, however, is too limited to sufficiently understand the decision-making process in Germany at federal level. The country's political economy system is characterised by a particularly tight interlock of societal and political actors, both vertically across different levels of government as well as horizontally across different entities at federal level. The vertical interlock stems, for example, from overlaps of powerful partisan interests across state, federal and EU decision-making bodies. At the same time, partisan as and other societal interests – such labour, employer, environmental, religious etc. interests – are represented horizontally across the decision-making bodies at federal level. This makes the identification of veto points in Germany – as Merkel (2003) points out – very difficult.

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

Third, the Veto Player Model fails to capture different forms of interaction between (groups of) agents. The model draws on economic theory, which shows how bargaining and exchange between agents leads to Pareto improvements of resource allocation. The decision-making process in the veto player framework is understood as a similar bargaining process among the veto-yielding agents. The policy options – equivalent to exchange options in the market setting – are limited by the winset, in which Pareto improvements for veto players are possible. By its very nature, the form of political interaction of the veto players is consensual; actors are willing to constructively interact with other actors. A key underlying assumption of this approach is that actors genuinely care about the implemented policy and about changing the policy status quo towards their policy position. The motivation to veto a policy reform initiative may, however, be driven by other considerations than policy substance. Partisan veto players are, for example, commonly driven by vote or office seeking motives. A veto may thus be used to hurt the reputation of the government rather than to exert influence on policy substance. These veto players have been referred to as ‘competitive veto players’ in distinction to the conventional ‘cooperative veto players’ in the Veto Player Model (Wagschal, 1999; Crepaz, 2001; Wagschal, 2005; Hohendorf et al., 2021).⁷ Also, the policy position of some institutional veto players – such as constitutional courts or central banks – will not typically reflect the aggregate policy preference of the collective actor, but be driven by the legal or statutory mandate of the actor.

In summary, the Veto Player Model was developed as a contribution particularly to comparative political science, aiming to ‘unify the comparative analysis of political systems’ (Ganghof, 2011, 2707). While it deserves much merit for allowing the joint assessment of seemingly incomparable political systems, it does less well in understanding policy dynamism over time, particularly in

⁷ Note that the logic of the Veto Player Theorem does not necessarily apply to the interaction of competitive veto players. For example, Tsebelis (2002) contends that the number of veto players is reduced if the policy position of two veto players overlap. This ‘absorption rule’, however, does not hold for competitive veto players, which may yield their veto for non-policy related reasons.

countries with a highly complex, interlocking politico-economic system. Accounting for the dynamics in policy preferences, all micro-political factors and the different forms of political interaction takes the compelling simplicity of the analytical framework *ad absurdum*. Thus, the original Veto Player Model loses much of its appeal for an analysis of Germany's structural reform trajectory over the past decades.

To address the problems of the original veto player framework for the analysis of countries such as Germany, this paper suggests breaking down the decision-making system into a number of sub-systems. The original Veto Player Model captures the entire political system in one single political bargaining game. Alternatively, this paper suggests analysing the policy proposal of an agenda setter in a number of sub-games, each of which captures an important aspect of political interaction in the economic policy-making process (see Figure 1 on page 7). More specifically, this adapted analytical veto player framework suggests the separate analysis of 'veto clusters' rather than all veto points at once. Following the original Veto Player Model, policy change in the augmented veto player model can come about if the policy proposal is not blocked by one or more veto clusters.

As the following study will show, the advantage of analysing the German polity in decision-making sub-systems allows a more differentiated understanding of the economic policy-making process. First, it is easy to see that this approach allows for different – cooperative, competitive and possibly other – forms of interaction among actors. For example, interaction among coalition partners in a government – a first cluster – may be ruled by genuine concerns about policy content, while interaction between the governing and the opposition parties – a second cluster – may be ruled more by office-seeking motives.⁸

⁸ Note that in the latter case the analysis of policy preferences and winsets of the original Veto Player Model is thus superceded by other factors and largely obsolete.

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

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

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

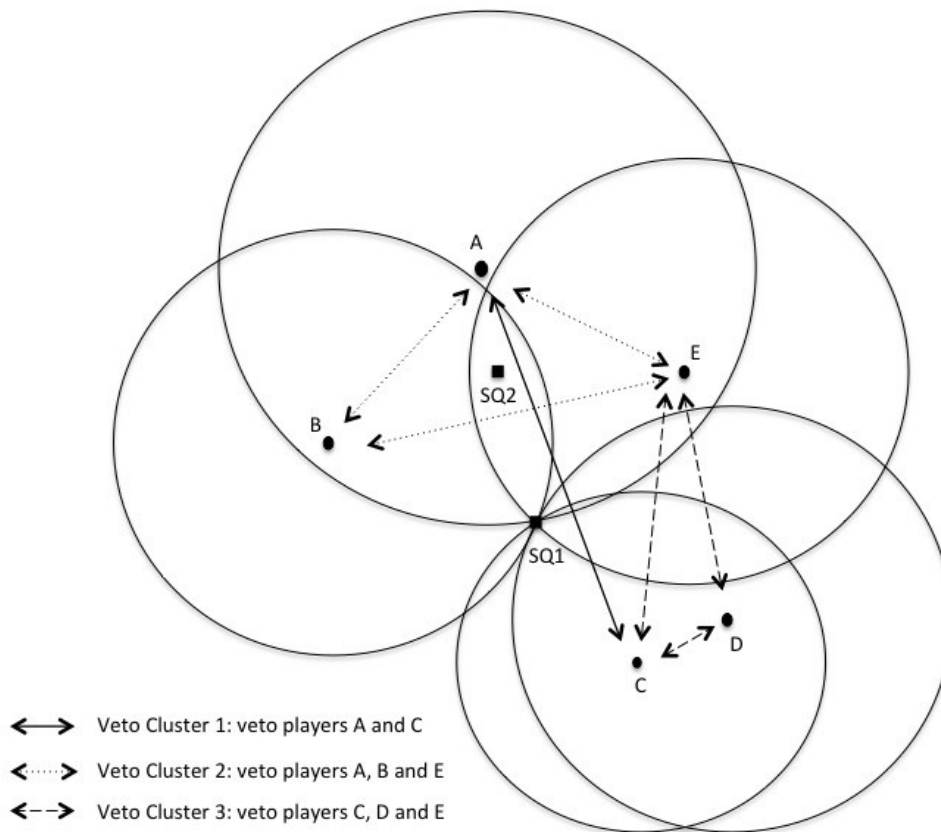


Figure 1: The political system consists of five veto players A, B, C, D and E. There are three veto clusters consisting of players A and C (Cluster 1), players A, B and E (Cluster 2) and players C, D and E (Cluster 3), which interact among each other. Note that veto players can be part of more than one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

Veto clusters in the German political system

Three veto clusters determine economic policy in Germany: (1) the relevant veto points within the federal government, particularly the coalition parties in the German *Bundestag*, (2) the relevant veto points in the federal legislative system, particularly also the political parties represented in the *Bundesrat* by means of their

governing majority in the *Länder*, and (3) the relevant veto points within the German system of corporatist interest representation, particularly the trade unions and employer organisations.

The first veto cluster in the German political system comprises the actors within the federal government (Cluster I). Both the electoral as well as the party system in Germany result in multiple parties being represented in the *Bundestag*, which requires careful coalitional engineering to form stable governments. Two parties – the CDU/CSU and the *Sozialdemokratische Partei Deutschlands* (SPD) – conventionally dominate the political agenda in Germany. However, as neither the CDU/CSU nor the SPD have ever been able to gain an absolute majority in an election at the federal level, German federal governments have always been coalition governments. The FDP, the only other party represented in parliament until the early 1980s, was joined by *Die Grünen* (greens, renamed *Bündnis90/Die Grünen* in 1993) in 1983, the left-wing *Partei des Demokratischen Sozialismus* (PDS, renamed *Die Linke.PDS* in 2005 and *Die Linke* in 2007) in 1990 and the right-wing *Alternative für Deutschland* (AfD) in 2013. Until 2005, economic policy changes have required the consent of either the FDP, which has been sternly pro-market since 1982, or the Green Party, which has settled for a moderately social democratic economic policy platform.

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

Arbeitnehmerfragen (AfA) has traditionally been close to the trade unions, while the *Seeheimer Kreis* represents the pro-market wing in the party.

The increased fragmentation of the German party system begs the question whether the CDU/CSU and SPD can still be referred to as catch-all. With the rise of *Die Linke* on the political left and the AfD on the right, it may be argued that SPD and CDU/CSU are constrained to represent the interests of the narrower centre-left and centre-right. Some argue that reduced policy space resulted in catch-all parties turning into ‘cartel parties’, which have abandoned inner- and inter-party competition and merely aim to preserve their position in the political system (Mark and Katz, 2005). Evidence suggests, however, that pluralism and competition of ideas are alive in both the SPD and CDU/CSU. For example, following the loss of power of SPD and greens in 2005, the pro-market wing in the SPD lost influence vis-à-vis the party traditionalists. Similarly, battles for influence persist also between different camps in the CDU/CSU. After almost 16 years of relatively progressive and socially-minded policies by the Merkel-led party, the party under the leadership of Friedrich Merz is expected to be more conservative and market friendly.

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

This point is crucial because the governing coalition usually does not have the support of the *Bundesrat*, i.e., the state governments represented in the federal chamber are backed by parties that are part of the opposition in the *Bundestag* (two out of three years since 1949). Burkhart and Manow (2004) show that, while the number of legislative proposals actually vetoed by the *Bundesrat* is not significantly higher in divided government than in cases when the same parties have a majority in both the *Bundesrat* and the *Bundestag*, the 'anticipated veto' by the *Bundesrat* will effectively stop the government from initiating far-reaching policy reform and structural reforms.⁹

The third veto cluster captures the system of corporatist interest representation in the German political system (Cluster III). This system includes arrangements by which interest groups are included in the political decision-making process. These interests groups comprise first and foremost the trade unions represented by the *Deutscher Gewerkschaftsbund* (DGB) – including *IG Metall*, *OTV* and *Ver.di* (now *Ver.di*), *IG Bergbau, Chemie und Energie* among others –, employer organisations – including the *Bundesverband der deutschen Industrie* (BDI), the *Bundesvereinigung der deutschen Arbeitgebervertretungen* (BDA), the *Zentralverband des deutschen Handwerks* (ZDH) and the *Deutsche Industrie- und Handelskammertag* (DIHK) among others – as well as welfare associations. These social groups are represented in the governing bodies of important para-statal institutions, such as the federal labour office, the social security institutions, universities and the public broadcasters.

Beyond the tripartite-governed para-statal institutions, however, they also exert informal political influence, particularly by means of close linkage to political parties. For example, there are traditionally leadership overlaps between the

⁹ Note that this veto cluster diverges from the 'Joint Decision Trap', put forward by Scharpf (1988). The joint decision trap describes how a federally-organised entity such as Germany (or the EU) is biased towards lowest common denominator policy decisions due to the veto power of *Länder* governments. Scharpf assumes autonomous policy decisions by *Länder* governments. For the purpose of this paper, it is argued that party discipline compels *Länder* governments to adhere to the federal party policy line. This assumption is reasonable for policies pertaining to federal legislation on wage bargaining, unemployment protection, unemployment benefits, health insurance etc.

political parties, trade unions and employer organisations (Hassel, 2006). The closely interlocking network ensures strong political influence of interest groups – particularly of trade unions and employer organisations – on economic policy. In fact, social partnership between government, trade unions and employer organisations that allows resolution of conflict through institutionalised cooperation has long thought to be a hallmark of German corporatism (Streeck, 2005b). In consequence, the social order and economic governance in Germany depends, ‘not on the strength of the state, but on a balance of power between social groups as well as on a corporatist pattern of social organization’ (Streeck and Hassel, 2004, 103).

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

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

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

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

3. Economic policy continuity

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

Economic policy in Modell Deutschland

The central obstacle to reform in Germany in the 1980s was not the first or the second veto cluster – the federal government or the federal legislative system – but Germany's corporatist structure (Cluster III). The German economic model – the so-

called *Modell Deutschland* – worked well for the dominant interest groups: trade unions and employer organisations representing Germany’s manufacturing sectors. Fundamental change of the institutional structure of the German economic model did not find their approval. Beyond some limited budget consolidation, the Kohl government implemented none of its announced structural reforms (Zohlnhöfer, 2001).

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

Despite this Thatcherite rhetoric, however, no radical changes in the German political economy followed. The value-added tax was increased and spending for selected welfare programs was moderately reduced. For example, a 1983 act accompanying the budget moderately linked unemployment benefit duration to the record of social security contributions. However, the bulk of the budget deficit reduction was financed through the rebounding German economy of the mid-1980s. A vocally advertised income tax reform only marginally reduced the average tax

¹⁰ Data source: Own calculations based on DESTATIS data

burden in the second half of the 1980s. The 'reform' of the legal shopping hours symbolises the overall hesitant reform policy of the time: shops were allowed to remain open two more hours a week (Webber, 1992; Katzenstein, 1989).

In spite of the economic recovery after the 1982 recession, with growth at around two percent for most of the later 1980s, unemployment remained stubbornly high at around eight percent.¹¹ This continued to be a pressing problem for the government. Consequently, more radical reforms of the labour market and the welfare institutions should have been easy to rationalise.

If only the two political veto clusters – 'federal government' and 'federal legislative system' – are taken into account, the lack of more radical policy change remains surprising. In fact, the conditions for fundamental economic reform seem highly favourable. First, the CDU/CSU enjoyed very good ratings in the polls, marshalling considerable 'electoral slack' throughout the 1980s. The Christian democratic liberal government had already won a majority of seats in the *Bundesrat* in 1972. Also, the CDU/CSU's coalition partner, the FDP, had left the coalition with the SPD hoping to achieve its market-oriented economic policy goals with the help of the Christian democrats.¹² That is, coalition politics and majorities in the *Bundesrat* were conducive to a more radical reform policy. This leaves the corporatist structures of the German economic model as the decisive determinant for institutional stability.

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

¹¹ Data source: Own calculations, IMF World Economic Outlook

¹² In 1982 the liberal German Minister for Economic Affairs, Otto Graf Lambsdorff, published a 'Concept to Overcome Low Growth and to Fight Unemployment', renouncing the Keynesian economic policy of the SPD and FDP coalition government. This change in economic policy of the FDP triggered the end of the SPD/FDP coalition.

manufacturing niches, a close coordination of business interests, particularly in the *Mittelstand*, co-determination in corporate management, and a sophisticated system of vocational training, among other elements.¹³ The Varieties of Capitalism literature (Hall and Soskice, 2001) develops a model of ‘coordinated market economies’, showing how firms may use institutional elements found in the *Modell Deutschland* to their advantage. Maintaining that Germany had (and still has) a ‘comparative institutional advantage’ in ‘diversified quality production’ (Sorge and Streeck, 2018), the model provides a compelling argument for why Germany’s socio-economic institutions facilitated its ascent to world-leadership in the export of high-quality manufacturing products such as luxury cars and machine tools.

It is easy to understand that neither trade unions nor employer organisations were interested in changing this institutional regime so long as it ensured good annual accounts for manufacturing firms as well as secure, well-paid jobs for their employees. Growth, both of corporate profits and household income, in the German manufacturing sector in real terms were negative in the early 1980s. After 1983, however, real corporate profits grew by an average of over 4 percent, while real household income in the manufacturing sector grew by over 3 percent on average. At the same time, growth of profits and income in the non-manufacturing and particularly in the service sectors was significantly lower.¹⁴ In short, the Germany’s specialisation in a skill-intensive, high-quality production regime paid off for the trade union and employer organisation members.

Second, trade union and employer interests were effectively transmitted into the political decision-making process particularly through their influence in the party system. On the one hand, labour-friendly social committees inside the CDU/CSU exerted substantial influence on the economic agenda of the CDU/CSU. Here, it is worth pointing to the strong political position in the CDU of the committee

¹³ For two discussions of the term *Modell Deutschland* – from a German and an Anglo-Saxon perspective – see Offe (2002) and The Economist, 14 April 2012

¹⁴ Data source: Own calculations from OECD STAN database

chairmen Norbert Blüm (who was simultaneously a member of the CDU's executive board and Minister of Labour from 1982 to 1998) and Heiner Geissler (who was Secretary General of the CDU). On the other hand, the interests of large- and medium-sized firms were effectively represented in the CDU/CSU by the influential *Mittelstands- und Wirtschaftsvereinigung* (Zohlnhöfer, 2001, 42). Regarding the CDU/CSU's junior coalition partner, the FDP always had close ties to corporate interests, the party's core constituents being 'entrepreneurs, middle-class intellectuals as well as business and industry executives' (Kortmann, 2010, original in German).

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

Instead of dismantling integral elements of Germany's coordinated market economy, the government returned to demand-side policies. This kept excess labour supply off the market by increasing the social budget. First, the government stepped up its active labour market policies and wage subsidies. Expenditures for these measures rose by 10-20 percent annually until the end of the 1980s (from EUR 14.5 billion in 1985 to EUR 25.1 billion in 1990).¹⁵ Second, the government began encouraging early retirement. These schemes helped firms adjust their labour

¹⁵ Data: Own calculations, IMF World Economic Outlook

demand despite highly regulated labour markets. Because companies massively applied these early retirement schemes to lay off workers (Trampusch, 2005), the cost of these schemes rose from EUR 95 million in 1985 to EUR 546 million in 1989. By the late 1980s, labour market participation of men between the ages of 60-64 reached only 30 percent, while it stood at 55 percent in the United Kingdom and 65 percent in Sweden (Wood, 2001b, 387). The government's tacit support to the German manufacturing sector has been referred to as 'welfare corporatism' (Streeck, 2005a, 141).

Economic policy after reunification

Following German reunification, the anchor for institutional stability shifted from corporatism to the federal legislative process, from Cluster III to Cluster II. After a short post-reunification consensus between the major political parties, business and labour – helped by the domestic demand boom from 1990 to 1992 – the government embarked on new structural reform initiatives. At the same time, the financial burden of reunification on the German welfare system was putting into question core pillars of the *Modell Deutschland*. This weakened the reform-decelerating powers of the corporatist veto cluster. However, the loss of a majority in the *Bundesrat* hindered the Christian democratic/liberal government from enacting more far-reaching structural reforms.

The fall of the Iron Curtain in 1989 and the subsequent, surprisingly fast reunification of Germany in 1990 were bound to preoccupy German political economy. While the political reunification turned out to be less onerous than anticipated, the economic unification of the strong West German economy with the derelict economy of Eastern Germany proved to be very difficult. Kohl's stated primary post-reunification goal was to create equal living standards in the eastern and western regions of the country (Art. 34, Treaty on the Establishment of German Unity). This entailed huge investments to overhaul the decayed eastern infrastructure. Because East Germany *de facto* acceded to the West German

constitution, socio-economic regulations and welfare institutions were automatically applied to former East Germany. With huge increases in unemployment following closure of large sections of the planned economy's industries in the East, active labour market policy and early retirement – which had worked well to stabilise unemployment rates in the 1980s in the former West Germany – became the preferred policy measure to maintain social peace (Wood, 2001b, 388). The cost peaked at EUR 52.2 billion in 1992 for active labour market measures and at EUR 18.6 billion in 1993 for early retirement measures.¹⁶ Between 1990 and 1995, 57 percent of the former East German work force took part in active labour market programs (Zohlnhöfer, 2003, 141).

The loose fiscal policy and the one-to-one exchange of the East Mark to the German Mark led to a post-reunification boom, with growth rates of 5.7 percent and 5 percent in 1990 and 1991, respectively. The ensuing high inflationary pressure prompted the *Bundesbank* to drastically increase interest rates, pushing the German economy into recession in 1993. The subsequent rise in unemployment increased the budgetary problem of the government still further, leading to substantial reform pressure by the mid-1990s. The pressure to lower the deficit was further amplified by the need to fulfil the Maastricht criteria of the European Monetary Union (EMU), a second political priority of the Kohl government. Attempts to consolidate the budget by introducing special taxes, cut-backs in welfare spending and a reduction of subsidies, produced only short-term effects; the deficit reached a new all-time high in 1996.

In 1995/1996 the number of unemployed reached the 4-million threshold for the first time. In an attempt to reduce unemployment, the government enter into a tripartite agreement, the 'Alliance for Jobs' (*Bündnis für Arbeit*), with trade unions and employer organisations in 1996. This move was patterned on the 'concerted action' (*Konzertierte Aktion*) approach of the 1960s and 1970s. In a joint declaration,

¹⁶ Data source: Own calculations, IMF World Economic Outlook

the government, employer organisations and unions agreed on the target to cut unemployment by 50 percent by the end of the decade by. After several informal consultations, however, the 'Alliance for Jobs' ended in April 1996 without an accord, mainly because no agreement on labour market liberalisation could be reached. The 'attempt to use the social capital accumulated in the associations for fundamental reforms' (Streeck, 2000, 56, original in German) had failed.

After the 'Alliance for Jobs' came to an end, the Kohl government unilaterally put forward far-reaching economic policy reform proposals, aimed at drastically cutting back expensive demand-side labour market policies. With its majority in the *Bundestag*, the coalition amended the 'Protection against Dismissals Act' as well as other labour market regulation.¹⁷ However, central elements of the labour market reform, pertaining particularly to the benefit system and requiring approval from the *Bundesrat*, did not pass the legislative process.¹⁸ At the same time, a major overhaul of the German income tax system – one of the core policy objectives of the FDP, aimed at reducing non-wage labour costs and increasing work incentives – failed outright in the legislative process after long negotiations.¹⁹ Against this background, it is unsurprising that the Association for the German

Language chose *Reformstau* ('reform blockade') as the 'word of the year' in 1997.²⁰

How can this economic policy turnaround be explained? Growth and unemployment rates were not significantly worse after the early-1990s recession than they had been following the early-1980s recession. However, in a reaction very dissimilar to that of the mid-1980s, the Kohl government turned away from the

¹⁷ More specifically, the government raised the threshold above which employment protection is applicable from five to ten employees, liberalised the use of fixed-term work contracts, cut sick pay to reduce non-wage labour costs (the issue over which the 'Alliance for Jobs' had fallen apart), tightened the criteria under which benefit recipients could refuse a job, and reduced the content of active labour market policy. Associated Press, 7 November 1996.

¹⁸ Frankfurter Allgemeine Zeitung, 30 November 1996

¹⁹ Die Welt, 27 March 1997, Westdeutsche Allgemeine Zeitung, 10 July 1997, Frankfurter Allgemeine Zeitung, 30 July 1997

²⁰ Die Zeit, 18 December 1997

'social partnership' and with its reform policy 'threw down the gauntlet to social peace' in Germany.²¹ Social scientists are puzzled that the social committees within the CDU/CSU could not or did not want to prevent reform initiatives from entering the legislative process the way they had in the 1980s (Zohlnhöfer, 2004, 313).

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

From the perspective of employers, the convenient system of 'welfare corporatism' and collective wage agreements was increasingly becoming a liability for international competitiveness, particularly for medium-sized employers in the *Mittelstand*.²² The post-reunification unemployment shock led to a steep rise in nonwage labour costs from around 70 percent of direct compensation in the 1980s to almost 85 percent in the mid-1990s.²³ Large firms were able to relocate labour-intensive production abroad or pass on the costs to their suppliers, but small- and medium-sized firms were forced to bear the cost. Accordingly, with the exception of the post-reunification boom years, profits of German manufacturing firms developed negatively in real terms through most of the 1990s.²⁴ Small firms increasingly viewed the labour market institutions of the *Modell Deutschland* as a

²¹ Süddeutsche Zeitung, 29 April 1996, original in German

²² 'Non-wage labour costs in Germany reach new record high', European Industrial Relations Observatory, 28 May 1997

²³ Data source: DESTATIS labour market database

²⁴ Data source: Own calculations from OECD STAN database

burden rather than an asset for their business operations. With this, key components of the ‘coordinated market economy’ were being put into question.

As a result of these developments, a conflict emerged particularly between more and less exposed firms inside the employer organisations regarding the direction of economic policy in Germany (Baccaro and Benassi, 2016). The conflict surfaced, for example, in the attacks of the reform-minded chairman of the BDI, Hans-Olaf Henkel, against the BDA.²⁵ While the BDI pressed for far-reaching structural reforms, the BDA defended core elements of the German economic model (Streeck and Hassel, 2004). Many small- and medium-sized firms started leaving employer organisations (Thelen and van Wijnbergen, 2003; Silvia and Schroeder, 2007). Discord among different types of employers in the German economy led to a weakening of the political influence of the employer organisations (Lehmbruch, 2000).

From the perspective of trade unions, reunification also had severe repercussions. Real income of manufacturing workers had reliably increased through the 1980s and early 1990s, at about twice the rate as in the general economy. In the mid-1990s, however, income growth slowed to below 2 percent, also on account of the increase in social security contributions.²⁶ At the same time, increasing decentralisation of wage bargaining – particularly in Eastern Germany – combined with high unemployment and changing work environments (Schroeder, 2003) also contributed to a significant decrease of unionisation (Hassel, 1999). Union membership of the working population fell from around 36 percent in 1991 to about 24 percent in 2000.²⁷ Lower levels of unionisation not only put substantial financial strain on the trade unions, but – as interview partners confirm – also started undermined their legitimacy in the eyes of policy-makers.

²⁵ Der Spiegel, 23 September 1996, Der Tagesspiegel, 7 July 1998

²⁶ Data source: Own calculations from OECD STAN database

²⁷ Data source: Armingeon et al. (2021)

As a result of these developments, interests between traditionalist and more reform-minded trade unions diverged. This conflict is demonstrated, for example, by the policy struggle between the traditionalist head of *IG Metall*, Klaus Zwickel, and his reform-minded deputy, Walter Riester.²⁸ Internal conflict over policy severely weakened the political influence of the labour movement. It also accounts for the declining influence of the trade unions the CDA, the labour wing in the in the CDU (Zohlnhöfer, 2003). By the late 1990s, not one of the board members of German trade unions was simultaneously a party executive.²⁹ With their internal cohesion, the ability of the labour movement to uphold the status quo was faded.³⁰

The resulting weakness in the corporatist veto cluster, which had prevented liberal market reform in the 1980s, did not, however, open a window of opportunity for more decisive structural reform. Note that the 'federal government' veto cluster (Cluster I) remained accommodative to more far-reaching structural reforms: It was the FDP, for example, that pushed its CDU/CSU coalition partner to bring forward the tax reform initiative, which was originally foreseen for after the 1998 elections.³¹

Rather, through the mid-1990s, the 'federal legislative system' veto cluster (Cluster II) created a strong anchor for the institutional status quo. The coalition parties in the federal government – CDU/CSU and FDP – had lost their majority in the *Bundesrat* in 1991. In the early 1990s, the government had been able to cooperate with the opposition by appealing to a 'post-reunification consensus'. Following the economic crisis, however, the opposition adopted a confrontational strategy. From 1995, the new chairman of the SPD, Oskar Lafontaine started to use the *Bundesrat* as a veto tool to undermine the federal government's legislative programme and boost

²⁸ Der Spiegel, 13 October 1997, Focus, 17 November 1997

²⁹ While during the 1980s 97 percent and 20 percent of SPD and CDU/CSU members of parliament, respectively, were trade union members, these numbers had shrunk to 80 percent and 20 percent by the mid-1990s (Hassel, 2006).

³⁰ An early indicator of the union weakness in the 1990s was the quick, EU-induced privatisation of several state-owned companies in the transport, postal service and telecommunication sector, which the unions were unable to stop. cf. Süddeutsche Zeitung, 29 June 1994

³¹ Die Welt, 20 August 1996, Die Zeit, 29 November 1996

the public profile the SPD. After 16 years in opposition and in view of the electoral success of social democratic parties in other large European countries at the time, office seeking motives strongly dominated policy considerations in the SPD. Major legislative initiatives to reform labour market institutions and the tax system were thus rejected or watered down by the *Bundesrat*.³² The FDP chairman, Wolfgang Gerhard, complained 'We are in government, but we are not in power!'³³

Economic policy under Schröder I

The first years of the government of Gerhard Schröder were characterised by severe intra-party conflict. This shifted the determinant for institutional stability from the 'federal legislative system' to the 'federal government' veto cluster, from Cluster II to Cluster I. Following a demand-side economic policy in the months after taking office from the Kohl government, the government's attempts at supply-side institutional reforms were largely foiled by resistance from within the governing coalition (Egle et al., 2003).

When SPD and the Greens gained a majority in the 1998 elections, this marked the first time all governing parties were completely replaced by opposition parties in the history of the Federal Republic. Given soaring unemployment and budget deficits, a break with unions and subsequent market-oriented reform attempts, the Christian democratic liberal government had lost the trust of the electorate. A growing perception of a 'justice gap' (*Gerechtigkeitslücke*) emerged (and was actively kindled by the opposition parties), especially in Eastern Germany, where more than 60 percent of the voters moved to the left of the political spectrum, namely the SPD or the PDS.³⁴ With the slogan 'Social Justice and Innovation', the double act of Gerhard Schröder and Oskar Lafontaine, and a professionally organised election

³² Associated Press, 25 September 1997, see also (Lees, 2000)

³³ Die Zeit, 10 July 1997, original in German

³⁴ Frankfurter Allgemeine Zeitung, 14 October 1998

campaign, the SPD managed to draw votes also from reform-oriented conservative voters (Stöss and Niedermayer, 2000).

In terms of economic policy, the government's first months were dominated by a demand-side approach. The 1996 labour market reforms of the Kohl government were revoked, a move that the SPD had promised to carry out in its election campaign.³⁵ In consequence, public expenditures for welfare measures rose by 6.8 percent. Included in this demand-side economic policy was an income-tax reform that decreased the lower tax bracket and increased the tax allowance. As a concession to the green party coalition partner, an ecological tax (*Okosteuer*) on energy consumption was introduced and used to support pension funds. By bringing back to life the 'Alliance for Jobs' (renamed 'Alliance for Jobs, Training and Competitiveness'), the SPD hoped to revive the corporatist institutions that had been challenged during the last years of the Kohl government (Schroeder, 2003, 12). In particular, the government tried to have trade unions agree to an employment-friendly policy.³⁶

The economic policy approach of the Schröder I government changed significantly, following the departure of Lafontaine as finance minister and chairman of the SPD. On finances, Schröder replaced Lafontaine with Hans Eichel, a fiscal conservative. The new finance minister started implementing some limited spending cuts in the welfare and pension system. However, after losing elections in several *Länder* (and subsequently the majority in the *Bundesrat*) and with disastrous results in European Parliament elections, further economic imposition were shelved.³⁷ At this time, the pressure to reform was reduced considerably as unemployment declined and growth rates picked up in the course of the global

³⁵ The reintroduction of social security contributions for low income jobs (so-called *630-DMJobs*) and rules against pseudo self-employment were especially heavily criticised by employers (Egle, 2006; Rose, 2003), who warned that the low-wage sector would be pushed back into illegality.

³⁶ However, no compromise could be reached. Apart from the very limited so-called 'JobAQTIV' labour market law on activation and training measures, concrete results of the "Alliance for Jobs" are difficult to identify (Heinze, 2003; Reutter, 2004).

³⁷ Der Spiegel, 13 June 1999, Berliner Zeitung, 6 September 1999

internet-economy boom. What followed until 2002 came to be known as the ‘policy of the steady hand’³⁸, although the government did introduce some incremental pension and corporate income tax reforms in 2000/2001.³⁹ Overall, however, and despite the incoherent policy profile in social, fiscal and employment matters, traditional social democracy dominated the SPD economic policy agenda until the end of Schröder I.

This economic policy is explained by substantial intra-party conflict within the SPD, which can be understood in terms of the ‘catch-all party problem’ in Cluster I of the analytical framework. In 1998, the SPD rode a wave of ‘new social democracy’ that was sweeping through Europe at the time, namely the United Kingdom, France, Sweden, Portugal and Italy. But the vague concept *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, 73). The SPD programme lacked a ‘concretion of social democracy’s basic values liberty, equality and solidarity’ (Meyer 2001, 13, original in German, Egle 2006), resulting in conflict between modernisers and the traditionalists over the economic policy direction of the government.

This conflict emerged most visibly in the rivalry between Lafontaine and Schröder. The balancing act between the two, which had carried the SPD into government in 1998, quickly broke down after the election.⁴⁰ Lafontaine was a self-proclaimed left-Keynesian. Schröder’s approach to economic policy is characterised by pragmatism and reformism.⁴¹ At the same time, Schröder surrounded himself with reformist social

³⁸ Frankfurter Allgemeine Zeitung, 12 July 2001

³⁹ The rise of pensions was decoupled from the rise in living standards, and linked to the rise in prices. With the *Riester-Rente*, a second, private pillar in addition to the public pension fund was introduced (Schmidt, 2003a, 247-251). The corporate income tax reform lowered the corporate tax rate, but also provided tax breaks on profits from the sale of cross-shareholdings.

⁴⁰ Der Spiegel, 4 October 1999

⁴¹ A close advisor describes his role – then as minister president of Lower Saxony – in committees as follows: ‘Schröder never – in contrast to his eternal adversary Edmund Stoiber – prepared for meetings particularly thoroughly. He would listen to technical discussions passively. However, he would typically be the one to make the winning, compromise proposal.’ (original in German, see also Murswieck (2003); Egle (2006))

democrats, such as Bodo Hombach (Federal Minister for Special Tasks), Frank-Walter Steinmeier (Chief of Staff in the German Chancellery), Alfred Tacke (State Secretary at the Federal Ministry of Economics and Technology) and Uwe-Karsten Heye (Government Spokesperson). He maintained close ties with German industry, which he had established during his time as minister president.⁴²

Although the modernisers in the SPD gained the upper hand over traditionalists, Schröder's subsequent attempts to introduce supply-side structural reforms failed due to the resistance of his own party, which – as interview partners close to the government explained – was not 'ready' for more innovative policy changes. In June 1999, Schröder and Britain's Prime Minister Tony Blair published a paper titled, 'The Way Forward for Europe's Social Democrats' (Blair and Schröder, 1999), which can be understood as an attempt to reaffirm the chancellor's commitment to the 'Third Way' concepts and as a rejection of Keynesian policies. Both the paper and the fiscal consolidation policy evoked strong resistance from the SPD labour committee AfA and the parliamentary fraction. Labour representatives called the Blair-Schröder paper a 'historically blind defamation of the welfare state.'⁴³

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

⁴² Die Zeit, 14 March 2002

⁴³ Frankfurter Allgemeine Zeitung, 10 July 1999, original in German

The analysis of policy preferences in the federal government veto cluster suggests that intra-party conflict (Cluster I) was the decisive anchor for institutional stability in the Schröder I government. The ‘federal system’ and ‘corporatism’ veto clusters only had a secondary role. With regards to the role of the federal legislative system, the SPD lost its majority in the *Länder* just a year after coming to power. With the majority in the *Bundesrat*, conservative parties were able to block structural reform initiatives of the government. Indeed, the *Bundesrat* blocked a more significant reduction of subsidies in the context of its 2000 tax reform.⁴⁴ Overall, however, there were few supply-side reform projects were introduced into the legislative process.

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

4. Economic policy under Schröder II: The Agenda 2010

The following section provides a short description and analysis of the Schröder II government and its central economic policy programme; the Agenda 2010.⁴⁵ It argues that the government was able to implement these Agenda 2010 reforms

⁴⁴ Handelsblatt, 14 June 2000

⁴⁵ For a detailed description of the economic policy of the Schröder II government, please refer to Egle et al. (2006), for example.

because all three veto clusters of the German political economy had lost their constraining power.

In 2001/2002, the economic situation in Germany deteriorated drastically, in step with the global economic downturn following the 911 terror attacks. Growth rates plummeted (from 3.2 percent in 2000 to zero in 2002), and unemployment rose quickly (from 7.8 percent in 2001 to 8.7 percent in 2002), putting pressure on the government to end its 'steady hand' policy. A scandal in the Federal Labour Agency in spring 2002 served as an opportunity to reopen the structural reform debate. Schröder not only replaced the head of the agency and modernised the corporate governance structure. More importantly, he set up a 'Commission for Modern Provision of Services in the Labour Market' (*Kommission für Moderne Dienstleistungen am Arbeitsmarkt*), tasked with developing a reform concept to make the German labour market and the job placement system more efficient. It became known as the 'Hartz Commission' after its chairman Peter Hartz, a former board member of the Volkswagen AG.

In August 2002, the Hartz Commission presented 13 reform proposals. These included a more far-reaching reform of the Federal Labour Agency. But the Commission also proposed measures to increase pressure on the unemployed, encourage the integration of the labour and social assistance administration, introduce a low-wage sector (*Mini-Jobs*), promote entrepreneurship (*Ich-AG*) and intensify the use of temporary employment agencies (*Personal-Service-Agenturen*). The national wage bargaining system was not touched by the proposals.⁴⁶

These proposals notwithstanding, the SPD was in danger of losing the September 2002 federal elections on the grounds of the country's poor economic performance. The CDU/CSU candidate, Bavarian minister president Edmund

⁴⁶ *Moderne Dienstleistungen am Arbeitsmarkt: Vorschläge der Kommission zum Abbau der Arbeitslosigkeit und zur Umstrukturierung der Bundesanstalt für Arbeit*, report of the commission under the chairmanship of Dr. Peter Hartz, see also Schmid (2003); Jann and Schmid (2004)

Stoiber, boasted better credentials on economic issues.⁴⁷ In the 2002 election campaign, Schröder promised to implement the reform proposals of the Hartz Commission 'one-to-one'.⁴⁸ The SPD's narrow victory was, however, not attributed to its economic reform agenda, but to the government's opposition to the US-led military intervention in Iraq and Schröder's shirt-sleeved handling of the Elbe-floods in the same year.⁴⁹

This 'blood and flood effect' – as one interview partner put it – did not last long, and the SPD lost dramatically in the polls in the first months of its second term in office. Instead of returning to a 'steady hand' policy, however, Schröder moved forward on the reform agenda. On 3 March 2003, he announced the breakdown of the 'Alliance for Jobs' – on which there had been no active negotiations for more than three years – and added that he intended to go ahead with a reform programme, without the participation of the social partners.⁵⁰ On 14 March, Schröder addressed the *Bundestag* and released details of a new, broad reform package, the Agenda 2010. The reform agenda addressed labour-market policy, taxes, higher education and job training, as well as the pension and health insurance system. The Chancellor justified his structural reform policies with the need to make Germany's social market economy sustainable: 'The alternative is obvious: Either we modernise our social market economy or we will be modernised by the untamed powers of the markets.' (Schröder, 2003, original in German)

The central element of the structural reform package was the change to labour legislation, which adopted most of the Hartz Commission's proposals. These proposals resulted in four new, separate labour market laws, known as Hartz I, II, III and IV. Employment protection was liberalised by the provision that dismissal protection applied only to firms with more than ten, instead of five, employees. The

⁴⁷ Handelsblatt, 8 April 2002, Financial Times Deutschland, 22 September 2002

⁴⁸ Handelsblatt, 18 July 2002

⁴⁹ Der Spiegel, 23 September 2002, Die Welt, 14 August 2012

⁵⁰ Der Tagesspiegel, 4 March 2003

legislation also merged secondary unemployment assistance (*Arbeitslosenhilfe*) with social welfare (*Sozialhilfe*) by creating *Arbeitslosengeld II* from January 2005 (known as 'Hartz IV'). Legislation additionally reduced the period of primary unemployment assistance (*Arbeitslosengeld I*) from 18 to 12 months (with an exemption for persons above the age of 55), thereby increasing the pressure on long-term unemployed people. The provision that unemployed people are compelled to take up any legal occupation was first removed due to pressure from inside the SPD, but later reintroduced on account of the opposition in the parliamentary arbitration committee. Finally, craft legislation was simplified by reducing the requirement of 'master craftsmanship' (*Meisterzwang*) from 94 to 41 crafts.⁵¹

The traditionalist camp inside the SPD was highly dissatisfied with the proposals and harsh critique came from the trade unions and welfare associations.⁵² For the political left, the Agenda 2010 heralded the end of the German welfare state and aroused fierce protest.⁵³ The reaction of employer associations was more positive.⁵⁴ 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).

The Agenda 2010 seems to fundamentally contradict established knowledge that institutional change in Germany is incremental by nature. The red-green coalition made a remarkable shift in its policy from its demand-side policies of 1998-1999 to the far-reaching supply-side reforms of 2003-2005 (Nachtwey, 2013). Let us again examine the three veto clusters, 'federal government', 'federal legislative system' and 'corporatist interest representation'.

⁵¹ This brief summary of Agenda 2010 illustrates that parts of the Hartz reforms were modelled on the 1996-1998 reforms of the Christian democratic liberal government, 'which following the change of Government in 1998 were deemed anti-social and repealed' (Ubberr, 2004, 136). However, the reforms then go well beyond the 1996-98 measures.

⁵² *Süddeutsche Zeitung*, 23 July 2003, *Frankfurter Allgemeine Zeitung*, 1 August 2003, *Handelsblatt* 23 October 2003

⁵³ *Süddeutsche Zeitung*, 11 December 2003

⁵⁴ *Die Welt*, 15 June 2004, see also (Weßels, 2006)

First, by the time of his second term in office, Schröder succeeded in established a cohesive federal government. After the departure of Oskar Lafontaine, SPD modernisers had gradually gained the upper hand on economic policy matters. Incremental reforms, such as the corporate tax reform of 2000 and the pension reform of 2001, stand in sharp contrast to the attempts of concerted action in form of the 'Alliance for Jobs' and indicate that the Schröder government was gaining more political room for manoeuvre.⁵⁵

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

Interviewees close to the decision-making process in Berlin also maintain that Gerhard Schröder gradually adopted a 'presidential' style of government.⁵⁶ This further contributed to the weakening of the SPD's labour wing, by making the policy-decisions more independent from opposition within his own party. Schröder's exceptional media skills were helpful in this context, earning him the title of 'media chancellor' (*Medienkanzler*).⁵⁷

Second, the CDU/CSU-led *Länder*, which held a majority in the federal chamber, did not block Agenda 2010. Although the CDU/CSU could have followed a vote-seeking, confrontational veto strategy similar to that of the SPD in the mid1990s, it

⁵⁵ The Economist, 20 July 2000, Handelsblatt, 17 December 2000

⁵⁶ see also Berliner Republik, June 2004 and Murswieck (2003)

⁵⁷ die tageszeitung, 6 September 2002

broadly decided on a policy-seeking strategy. Interview partners confirm that the conservative parties decided to cooperate politically, while voicing 'rhetorical critique' in public. The opposition called for restrictions on the independent wage-bargaining system, a demand that clearly was not going to be met by the government, for example. Nonetheless, opposition parties pushed the government towards more far-reaching reforms in the arbitration committee of *Bundestag* and *Bundesrat*.⁵⁸ Accordingly, Zohlnhöfer (2004) credits the CDU/CSU and FDP with exerting important influence on Agenda 2010, for example in the context of the liberalisation of mini-jobs and self-employment. Egle (2006) even refers to an 'informal grand coalition' between the red-green government and the CDU/CSU opposition majority in the *Bundesrat*.

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

A former senior German executive pointed out that 'the commitment from all partners to the industrial location Germany no longer existed'. This points to the fact that attempts to harness corporatist structures to build an agreement on institutional change failed because a basic consensus on the aspired economic model had gone missing. Schröder himself describes Agenda 2010 as a direct consequence of the failed *Bündnis für Arbeit*.⁵⁹ On the one hand, employer organisations had

⁵⁸ Der Spiegel, 17 October 2003, Frankfurter Allgemeine Zeitung, 19 December 2003

⁵⁹ Frankfurter Allgemeine Zeitung, 23 September 2004

increasingly taken a hostile position towards Germany's 'old' economic order and pushed for more far-reaching recalibrations. On the other hand, trade unions remained in a state of disorder. The creeping decentralisation of wage bargaining and the loss of members were forcing the trade unions to restructure and consolidate (Silvia, 2008). The relatively unobstructed implementation of Agenda 2010 is a strong indication that – for the time being – corporatism had lost its constraining power on German political decision-making.

It should be noted that the weakness of the *Modell Deutschland* in the 1990s and early 2000s did not result in its complete erosion and the end of corporatist policy-making. Indeed, Germany's economy outlook greatly improved in the second half of the 2000s, arguably also as a result of Agenda 2010 reforms (Zimmermann and Eichhorst, 2008; Rinne and Zimmermann, 2012). The rebounding German economy was even referred to as a second German *Wirtschaftswunder*. Rather than ending the corporatist German economic model, the Schröder reforms re-established the economic viability of the *Modell Deutschland*.⁶⁰

5. Conclusion

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

The theoretical section of the paper provides a critical review of the dominant analytical framework for institutional stability and change, namely the Veto Player Model. It argued that the Model quickly becomes overburdened if it attempts to factor in structural and dynamic elements of a complex political economy. The theoretical section presents an augmented veto player framework, which breaks

⁶⁰ The Economist, 4 January 2007 and 14 April 2012

down the politico-economic systems into a number of 'veto clusters'. This allows for a partial analysis of sub-systems that each follow a different political or political economy logic. It identifies three pivotal veto clusters within the German political economy, namely the veto points within the federal government, in the federal legislative system and in the system of corporatist interest representation.

An analysis of economic policy under Kohl and Schröder until 2002 shows that all three veto clusters of the German politico-economic system contributed to the lack of far-reaching structural reforms. Somewhat stylised, it could be argued that strong corporatist structures account for policy continuity in the 1980s, confrontation with federal entities blocked more far-reaching reform projects of the Kohl government in the 1990s, and low intra-party cohesion prevented innovative policy change under the Schröder I government (see Table 1 on page 26). The analysis of the German political economy under Schröder II demonstrates that the three veto clusters traditionally cohering the political economy in Germany were fading: the SPD modernisers had assumed control of the economic policy agenda setting; the opposition, which dominated the *Bundesrat*, accommodated supply-side policy changes; and the corporatist structures had been weakened too far to deter innovative policy change.

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

Table 1: Veto clusters and structural reforms in the German political economy 1982-2005

Veto clusters allows for a meaningful analysis of complex political economies over time. First, they allow for cooperative and competitive forms of interaction among actors. For example, interaction among veto players in the federal system

were highly confrontational in the late years of the Kohl government, but cooperative among veto players in the federal government. By contrast, in the first years of the Schröder government conflict emerged among the veto players in the federal government, while veto players in the federal system behaved relatively cooperatively. Second, the veto cluster approach allows reflecting the interlocking nature of the German political economy well. The same actors – for example, the parties with a majority in the *Bundestag* – can feature as veto players in more than one veto cluster – for example, in the federal government as well as in the corporatist system. Third, the partial analysis of veto clusters makes the incorporation of dynamics more manageable. This allows, in particular, the analysis of the impact of shifts of socio-economic structures on policy preferences and veto points.

Thus, the augmented veto player framework also provides a bridge between the agent-based and structural political economy analyses. This is illustrated by tracing the political implications of the gradual decline of support for the *Modell Deutschland*, culminating in the ‘Agenda 2010’ reforms. The catalytic effect of German reunification and global and European economic integration, among others, led to a change in the preferences of firms, trade unions and political parties that had previously jointly upheld the German economic model. Streeck (2008), Hassel and Schiller (2010), Fleckenstein (2011) and Fleckenstein and Lee (2017), among others, have developed important insights into how gradual shifts in Germany’s socio-economic structures led the way to welfare and labour market reforms.⁶¹ The augmented veto player framework allows to meaningfully reflect these insights in an agent-based model.

⁶¹ In this context, structural shifts should not to be misunderstood as the sum of numerous incremental institutional changes, i.e. ‘incremental change with transformative results’, as Streeck and Thelen (2005, 9) suggest. The analysis presented here shows how incremental change within a system of apparent institutional stability can reconfigure preferences and political constellations that, in turn, facilitate radical institutional change. Similarly, Dyson (2005) suggests that incrementalism could ‘disguise’ fundamental structural change by generating ‘tipping points’ of innovative policy change.

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