Germany's contribution to a European strategy

An economic culture of trust

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The German system of co-determination is often accused of developing with the growth of industry only to become a competitive disadvantage in the knowledge-based economy. The results of more recent researches in economic history show this to be a mistaken judgement.

Germany's social and economic system has been increasingly criticised in recent years with many questioning whether it is sustainable in the long-term. Doubts have concentrated on the specifically German principles underlying the way the economy is organised. Persistent mass unemployment since the 1980s has led to more and more frequent claims that the German system is incapable of adapting to new, innovative product markets, which, it is said, require highly flexible entrepreneurial decision-making processes in the context of globalisation. Although just ten years ago there was confidence in the economic and social superiority of the "Rhenish model of capitalism" (Michel Albert) in public discussion, and many experts still take this view, mounting scepticism means that many are now abandoning this position. The clash between American business culture and European business culture, as exemplified by Germany, has entered a new stage.

A key area of controversy is the system of industrial relations, in particular the German flagship policy of co-determination, or the right of employee representatives to participate in controlling workplace conditions and management decision-making. Co-determination is criticised for preventing quick decisions by senior management. Corporate governance is also seen to be handicapped by employees' participation – at least in large enterprises and in heavy industry. But these comparisons of the institutional advantages of different systems ('varieties of capitalism'), even where they are conducted systematically, normally do not include an economic analysis.

The judgement on the benefits that the German economy gains from co-determination swings between two assessments, which are not necessarily in conflict. The first assessment emphasises the way co-determination produces industrial relations peace, its calming and mediating influence, which serves Germany's social and economic system in the same way that a functioning welfare state does. This view reflects at least 50 years of positive experience with industrial democracy but avoids a clear statement about its economic value. The second assessment amounts to an assertion that co-determination threatens, like the welfare state, to become obsolete in the waning industrial age, because its core functions are intimately linked with the industrial economy and will therefore go down with it. This opinion rests on the basic assumption that the western world stands at the end of an era whose foundations were laid in the industrial revolution of the late eighteenth century and whose distinctly German traits have produced a system of industrial governance unique in the world. However, these two assessments, if they are valid in any way, do not describe the economic function of co-determination but rather, at best, one of its most obvious effects.

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Co-determination certainly has deep roots in the specific German path to today's economy, but definitely has more in common with the German origins of the new economy than with traditional patterns of industrialisation. In the race to industrialise, Germany was one of the stragglers, which had to develop its own institutions and organisations in the nineteenth century in order to catch up, or better still overtake, the pioneer, England. Although a legal framework for workers' committees to exercise co-determination rights was first established in an amendment of the Prussian Mining Law (1905), this innovation in industrial relations in fact broke through in the science-based new industries rather than the old ones. By around 1905 more than half of all machine-building companies – one of the new industries – had given co-determination rights to workers' committees, and two thirds of them rated the influence of the committees positively. Later the Weimar Republic introduced rights of co-determination at three separate levels: at the workplace, with the Works Councils Act of 1920; at the sectoral level, with the Central Joint Labour-Management Board of Economic Planning and Regulation (ZAG); and at the national level, with the Provisional National Economic Council conceived of in Article 165 of the Weimar Constitution. The controversies surrounding each of these achievements underscored their political character and social purpose, rather than suggesting that co-determination was necessary as a matter of corporate policy and business economics. Similarly in occupied Germany post-1945 the British insisted on granting employees equal voice on the supervisory boards of the iron and steel industry for socio-political rather than economic reasons.

During the 1950s the importance of stable, co-operative labour relations became readily apparent to most employers, and co-determination was one of the essentials for long-term productivity gains, growth, and competitiveness. However, even then the orthodox economic liberal theory of industrial relations, which continues to be dominant, saw co-determination as a strengthening of bargaining power and, so, of the unions' monopoly in the market. This theory argues that if a union can behave like the holder of a monopoly, it will try to maximise the wages of its members, while all the affected company can do is choose the employment level at which it earns maximum profit. From this perspective, the consequences are price rises and a misallocation of resources. As long as co-determination seemed appropriate to the preservation of a precarious social balance, even committed economic liberals were quite able to accept it for the sake of social peace and the stability in labour relations. But according to this theory with the end of industrial society and the declining importance →

→ of the production of goods, co-determination loses its legitimacy. Created to produce industrial stability it loses its effect once the industrial revolution has run its course.

Against this backdrop, co-determination's economic value can be reduced to the importance that long-term co-operative labour relations have in the process of value creation, or more precisely the costs involved in not having such relations. One element of this is the way that employees and their interests are organisationally tied into the company. To ensure that these ties exist, and to forge co-operative labour relations, employers may be prepared to pay the employees higher wages than is customary or to give broad guarantees of job security. Against this background employers can also invest in the initial and further training of their employees, an investment which is essential for increased profits, especially under the conditions created by the rapid move to the knowledge-based society. Reduced fluctuation and intensified motivation among employees make up for higher costs.

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The uneven distribution of knowledge in the workplace is another aspect of production relations in the knowledge-based society. So-called 'non-material production', the provision of services, depends on an intellectual expertise, which is difficult to replace and whose productive use in the work process cannot be easily controlled. It is impossible to set out in precise contractual terms what is the best performance by an employee with expert knowledge. And if it were possible such contracts could not be cost-effectively monitored and enforced. Management is thus steadily losing its ability to exercise absolute control over the workplace at reasonable cost. And when conflict arises, employees possessing specialised knowledge can damage the company more than could the traditional industrial worker, who had only generalised – and thus easily replaceable – knowledge. If the Leninist maxim of 'Trust is good, control is better' applied to the industrial context, the opposite is true under these new conditions. In addition, control is the more expensive option. As a result, management and employees or their respective representatives share control over the workplace.

Long-term, stable, and low-conflict labour relations are significant in yet another way, particularly in times of rapid structural change. A high level of qualification and initiative among the employees gives the business a greater incentive to make costly investments in fixed assets as they can be more confident that these investments can be fully used and depreciated. High fixed costs can thereby be turned into low unit costs. Investments in new technology raise the productivity of the company, expanding its share of the market and boosting profits. Adequate employee participation in these profits strengthens co-operative labour relations.

This is even more relevant for the postindustrial period. As the importance of services grew during the twentieth century, the incidental costs of providing them – in economic terms the transaction costs – also rose. This produced a greater need for institutional regulations and arrangements to keep these costs low. It is certainly true that the new production methods seldom jumped from New Industry to the rest of Germany's crisis-ridden economy, marked as it was by the conditions created by the two world wars and economic chaos. After dynamic beginnings at the start of the twentieth century, there was no major expansion in services and the conditions for innovative productivity did not spread to the economy as a whole. In fact, during the interwar period the position worsened relative to contemporary developments elsewhere, notably in the United States. Despite this, Germany, the pioneer of the 'Second Economic Revolution' (a term coined by the economics Nobel Prize winner Douglass C North) held to its course into the post-industrial age. Once established, the institutional context only changed gradually, despite all the external shocks. The same is true of co-determination – or rather, the principle of co-operative labour relations within the plant – and, to a lesser extent, other forms of co-operation beyond the plant level. Co-determination in Germany, which found a specific organisational form in the Weimar Republic and was perverted under the Third Reich, belongs to New Industry's institutional arsenal. The legal and organisational form of co-determination that emerged after 1945 was shaped by the political conditions of the times, but it was consistent with the economic needs of that period.

At the dawn of the twenty-first century, it is almost a truism that the value of 'human capital' is measured not only in terms of its own quantity and quality but primarily in terms of a society's aptitude for 'sociability', that is co-operation in the economic process based on trust, as Francis Fukuyama puts it. Without it, co-operation is feasible only by means of formal rules, regulations, and coercion. The resulting transaction costs escalate with the complexity of the tasks that a national economy must perform in order to be successful on the market, including the world market. Practically, mistrust thus has the same effect as a tax on economic activity. From the outset, the purpose of introducing co-determination in Germany was to minimise these costs. With the advent of New Industry in the twentieth century, the capacity for co-operation simply became more important. This sociability helps explain why the basic features of the German economic system, including co-determination, have survived all the political catastrophes of its era.

The high value attached to the economic culture of trust makes it understandable why post-war organisational forms of co-determination – whether in the iron, coal, and steel industry or in the Works Constitution Act of 1952 – were swiftly accepted despite their controversial beginnings. Above all, it explains their consolidation and practical development beyond what is laid down in the original legislation. The new perspective including historical research also sharpens the eye for other impacts. The origins of co-operative institutional arrangements – more narrowly, co-determination – do not lie in the rationale of a past industrial age. They are foundations of New Industry, the service sector, whose patterns of productivity are becoming ever more apparent as old industry's share of employment and value creation through manufacturing dramatically declines.

The economic value of co-determination and other forms of institutional co-operation does not stem solely from their ability to provide industrial and social peace and meet other socio-political goals but also from what they do to contain and reduce costs within complex market and production processes. Of course, this does not compel anyone to cling to outmoded organisational forms of co-determination. Appropriate institutional arrangements can certainly also be cast in other organisational moulds. But the laws of what is sometimes called 'asset specificity' mean that turning to such alternatives entails considerable cost. Because institutional change cannot be planned, success would by no means be guaranteed. There are therefore many reasons for the German model of co-determination to continue developing along lines that are determined by its past history, and so build on the capacity for co-operation that has accrued over the preceding 50 years or more. As long as this path corresponds to the way production is organised in society, it will not lead to some out-dated industrial past. It will instead ensure purposeful expansion of the institutional groundwork of New Industry right into the heart of the New Economy. ■

Further reading

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