The wonderful world of capitalisms

By Bob Hanké and David Soskice

Bob Hanké is studying for his PhD at the Massachusetts Institute of Technology (MIT) and doing research at the Wissenschaftszentrum Berlin (WZB). Prof. Soskice is Direktor of the WZB.
For Marx it was Manchester capitalism; for the 60s it was the French "le plan"; for the 80s it was Japanese "lean-production"; and now it is the US model of deregulation.

Each generation develops its own version of capitalism. But which version will survive?

Most analyses of recent forms of capitalism focus almost entirely on the macro-economic framework or the structure and organisation of the welfare state, including the role of the unions. Although they teach us a great deal about capitalism, they do not say very much about the capacity for survival of the different forms of capitalism and much less about the factors that make them successful. For most analysts the superiority of the Anglo-American model is assured, not least because those dealing in international capital understand and value the price and cost strategy that is implicit within it.

However, things are not quite so simple. For example, why during the 1980s did employers in Sweden, Germany, Austria and Belgium, despite having conservative governments, not attempt to deregulate labour markets in a major way? There is also no answer to the question as to why German and Swedish products still clearly differ in conception, design, engineering and price from American, Taiwanese or French products. Neither is there an explanation as to why German and Swedish products are, of course, still much more expensive than Japanese products.

In America and Britain co-operation between businesses, for example in relation to a common technology policy, is restricted, because of tight anti-monopoly rules. In Germany and France, on the other hand, it is much simpler. German and Swedish businesses have learnt how to live with strong unions - in Germany even with workers councils. In Britain and US companies the relations between employees and employer basically depend on the local power relationships between trade unions and management. At the same time in most northern European countries and Japan there is a carefully constructed vocational training system. This is missing in the USA and attempts to create such a structure have almost always failed.

The basic pattern is clear.

Companies can be divided into two groups - two "families of capitalism" - in terms of how, in their respective framework of institutions, they solve problems or have solutions imposed upon them. In the first group, which is most closely equivalent to the US model - what we call the "liberal market economy" - companies have a relatively large degree of liberty in the way they organise their labour relations. They see training simply as a cost and risk factor (something which in turn explains the lack of a developed education and training system) and depend on the capital they need from banks, that have a seat on their supervisory boards, while in the USA the stock market is by far the largest supplier of capital.

In America and Britain co-operation between businesses, for example in relation to a common technology policy, is restricted, because of tight anti-monopoly rules. In Germany and France, on the other hand, it is much simpler. German and Swedish businesses have learnt how to live with strong unions - in Germany even with works councils. In British and US companies the relations between employees and employer basically depend on the local power relationships between trade unions and management. At the same time in most northern European countries and Japan there is a carefully constructed vocational training system. This is missing in the USA and attempts to create such a structure have almost always failed.

The basic pattern is clear.

Companies can be divided into two groups - two "families of capitalism" - in terms of how, in their respective framework of institutions, they solve problems or have solutions imposed upon them. In the first group, which is most closely equivalent to the US model - what we call the "liberal market economy" - companies have a relatively large degree of liberty in the way they organise their labour relations. They see training simply as a cost and risk factor (something which in turn explains the lack of a developed education and training system) and depend on the stock market to finance their investments. Overall they operate in a legal framework which promotes competition. Within this institutional structure many businesses compete simply on the basis of price. Furthermore - although these factors are more evident in the USA than in the UK - there is an elite university system; deregulated financial and labour markets; and relatively lax bankruptcy laws. These are elements which favour high risk financing and generous financial incentives for scientists. The result is worldwide leadership in the area of new technology.

We call the second "family of capitalism", found above all in Germany, the "co-ordinated market economy". Here the system of labour relations, in which strong trade unions play a decisive role, is the result of an intensive process of negotiation. There is a highly developed educational and training system; banks play an important role in business; and companies operate on the basis of cooperation as well as competition. German products are, of course, still relatively expensive, but - by reputation - better than others.

Institutional equilibrium

The differences between German and American businesses are not accidental, rather they follow an innate logic. For example, how successful would the German engineering industry be without a training system, which provides companies with highly qualified skilled workers? How could these companies operate without the transfer of technology, which links →
The way German industry works makes it difficult for companies to compete in terms of cost

Making it difficult for companies to compete in terms of cost. Labour costs are too high, making it difficult for companies to compete in terms of cost. Labour costs are high and are difficult to reduce because of the industrial relations system. Suppliers are organised in such a way that it does not make sense to change them frequently. One reason for this is that large companies and their suppliers tend to build up long-term relationships offering advantages above and beyond that set out in the basic contract. Ending such a relationship could threaten large companies’ production strategies.

In the light of the conditions provided in this framework, it is almost impossible to carry out a strategy involving rapid change and competition on the basis of price. This explains why the development of software, biotechnology and complex high-tech systems - three typical examples of industries, where a rapid decision-making structure is essential to win new markets - has been relatively slow in Germany, despite the good reputation of German engineers.

The German financial system does not really help innovative companies involved in new technologies. Because a company’s reputation is often decisive in whether or not a bank provides credit, small and young innovative companies have particular difficulties in financing their investments. The conclusion: companies in the high tech sector in Germany often operate in an unfavourable environment. This is not to say that German companies are not innovative - the opposite is the case as a comparison of international patents shows - but they tend to innovate in existing technologies. In a “liberal market economy” like the USA things are much simpler. A deregulated labour market enables companies to keep their labour costs down and to pay good engineers enormous bonuses. In addition the financial system includes a so-called “high risk” component: there is a specialist stock exchange in the USA where innovative new companies are able to raise relatively easily. This is why American companies in the new growth sectors perform so well.

If one starts from the premise, that the ability to innovate in the area of new technology and competitiveness on the basis of costs are the key factors for success in the globalised economy of today, then one must question whether the German variant of “co-ordinated capitalism” can survive. Products are too expensive, it is said, because of the way the labour market is organised. Labour costs are too high, making it impossible to find a structural solution to the problem of unemployment. In other words labour market regulation is responsible for mass unemployment.

Beyond this the argument is advanced that German companies are not sufficiently innovative, which robs the German economy of a significant share of the market in new technologies. In the view of some industry experts it is precisely the close link between supplier and producer, which is a barrier to the development of completely new products - exactly what provides one of the few reliable areas of competitive advantage in today’s rapidly changing world economy. Does the German economy face a dismal future?

There are problems in Germany. This much is clear. But it would be wrong to look at the simple macro-economic explanation. Germany’s high unemployment is not purely the result of a rigid labour market but above all consequence of macro-economic conditions. The deliberately deflationary monetary policy of the Bundesbank (partially, although not entirely, the result of the strict Maastricht criteria) is decisive for all Germany’s European trade partners, with the exception of the UK. Without growth, even a flexible labour market provides no solutions. Unlike Germany, the USA and Britain are, despite what is often suggested, following an expansionary demand policy. The
problem of innovation, however, remains. Indeed both the Federal Chancellor, Helmut Kohl, and the Federal President, Roman Herzog, have recently joined those expressing concern. But here as well, the American example hides more than it illuminates.

The institutional framework in which US companies operate favours innovation. But it would be wrong to conclude from this that the German system of institutions only produces barriers. Over the last decade German companies have specialised in continuously improving innovations from other countries in order to bring them to market as high value specialist products. Despite stiff competition BMW and Mercedes still produce expensive cars - and sell them as well. The German engineering industry is prized worldwide for its high value products, tailored to specific customer needs. Hoechst, Bayer and BASF have won a global reputation for continuous product improvement. This list could extended much further but the point is clear: while the institutional framework in the USA promotes radical innovation, the German model favours an innovation strategy which is much slower, but produces a quality product.

In addition the German model has also proved its adaptability. The years of crisis in 1992 and 1993 saw restructuring in the motor industry and the engineering industry becoming competitive. The German chemical industry is attempting to incorporate innovations in bio-technology from the US within the German model, so combining the advantages of both systems. And trade unions as well as works council members have successfully argued for these innovations. Indeed in many cases they have been driving the process. They recognised that only an industry able to complete could guarantee employment.

Comparative advantages

Some 200 years ago the British economist David Ricardo developed the theory of comparative advantage. According to this some countries do better than others in particular sectors or products because of their natural advantages. Portugal - this was Ricardo’s proposal - should concentrate on the production of wine; Britain on textiles. He envisaged a system of trade which would enable both countries in an international division of labour to import respectively cheaper wine or textiles.

New growth theories, which see growth above all as the result of endogenous factors, are linked to this basic principle of Ricardo.

The arguments presented in this article are a further step in this direction. It attempts to explain the development of these internal factors and the way they grow together into an overall system. Today the issue is “comparative institutional advantages” rather “natural comparative advantages”. Particular institutional systems are, as we have seen, better suited to particular types of product development and innovatory processes. The world needs all the variants: Microsoft has a role to play just like Mercedes; Star Wars like Bosch; and Boeing like Bayer. American companies are perhaps superior in software, films and aircraft development; but, for the foreseeable future, the same is also true for German cars, engineering and chemical products.

That is why the wonderful world of capitalisms has a bright future.