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1 Good Neighbours: Germany and the Netherlands

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1.1 Introduction

All OECD Member States are confronted with a number of important structural changes. These common changes include: the internationalisation of the economies, the advances in information and communication technology, and the ageing of the population and the labour force. There are many definitions of internationalisation in use. A broad definition is: “the intensification of economic, political, social and cultural relations across borders” (Holm and Soerensen 1995, p. 1). Partly internationalisation is the result of a purposeful policy to lift barriers on international trade and capital flows. The new information and communication technologies also intensify and facilitate the internationalisation process. The third common change, the ageing of populations creates considerable pressure on the financing of social programmes. While expenditure on social programmes is rising due to the ageing of populations, the number of working age people will be growing only slowly or declining. A consequential fiscal crisis has to be prevented.

In order to deal in an appropriate way with these changes, each OECD country has to consider the question whether its institutional arrangements facilitate the adaptability of its economy. In this respect one often makes a distinction between the relative importance of the market and of the government in coordinating economic activities. The institutional differences between industrial countries can to a great extent be ascribed to a different mix of mechanisms that correct the results of the market process.

From the economic point of view, the consensus economy is a mixed economic order in which, besides the market and the government, a third mechanism of coordination is used, namely consultation. For example, through consultation between the employers' and employees' organisations and the government these three bodies jointly give direction to social-economic policy. In particular product markets, producers and consumers organisations and the government will consult
each other on issues like quality standards and prices. Following Albert (1991) a distinction can be made between two different variants of capitalism: the Rhineland model and the Anglo-Saxon model. The Federal Republic of Germany and the Netherlands, together with Switzerland, Belgium, Luxembourg, the Nordic countries and Japan, are variants of the *Rhineland model*. These countries are characterised by relatively much government involvement and tripartism as a coordinating device. Concertation is used instead of conflict, and these countries are aiming at long-term investments. The United States of America (USA) and the United Kingdom (UK) may be considered as variants of the *Anglo-Saxon model* characterised by little government involvement and coordination by the market, aiming at short-term results. In this book the focus is on the Federal Republic of Germany and the Netherlands. The UK and the USA are used as benchmark countries.

The structural changes put pressure on the social market economies and its institutions. The optimum relationship between coordination by the market and non-market coordination is a flexible one. There is disagreement as to which institutional arrangements best support the performance of the economy. One of the conclusions drawn at present by many researchers, policy makers and policy advisors (see for instance Den Broeder 1996; Fukuyama 1996; Streeck 1995) is that coordination by the market is better suited to deal with these trends. In making policy advice the *OECD Jobs Study* (1994a) is biased towards the market. The basic starting point of that analysis is that non-market institutions and (social) policy arrangements do have detrimental effects, i.e. in the long run the market always gives better results without than with policy interventions. In other words a rise of the Anglo-Saxon model is expected and the end of the Rhineland model is inevitable. Albert (1991) sees a battle between the Rhineland model and the Anglo-Saxon model. He concludes that the Rhineland model on which the Dutch and German welfare systems are based is loosing ground since the 1980s in favour of neoliberalism, despite the economic and social superiority of the Rhineland model. The market is considered good, non-market coordination is considered bad. Deregulation and privatisation became dominant policy issues. Albert sees a real danger that capitalism will derail. The concerted economy seems to have lost legitimacy because the presently so dominant neoliberal ideology is rather critical and distrustful of concertation and cooperative competition. The question is to what extent this critique and distrust is justified (Van Waarden 1997, p. 13): does concertation among competitors really reduce competition to such an extent that undeserved rents can be extracted from consumers and inefficiencies are being produced? Are the resultant contracts and regulations really the rigidities they are made out to be? Do they reduce competi-

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1 A third variant of capitalism is the Latin model, characterised by relatively strong government regulation and strong government policy impact on economic development. Activities by economic agents are directed towards the government in order to put weight to their demands. France, Spain and Italy are variants of the Latin model.
tion and increase costs to business, as many neoclassical economists maintain? Do such institutions increase equity in the market? Could they also enhance allocative and dynamic efficiency, the competitive position of sectors and national economies?

The Rhineland model with its extensive social safety net is deeply entrenched in continental Europe. This social model refers to a set of habits, assumptions and laws which though varying from country to country, is based on a view that society is better off if the representatives of labour, capital and the people at large, i.e. the government agree how best to run an economy (The Economist 5 April 1997, p. 13). The institutions of economic coordination that make national economies differ are the outcome of a path dependent long-term historical process, a process in which structures and cultural values that evolved at one point in time predetermined subsequent policy choices and institutional developments. Each nation has its own specific history. That is why the outcome of this long-term process differs so much. This implies also that economic institutions are for their effectiveness and legitimacy dependent on other institutions and cultural values present in these societies. They 'fit' in a pattern of institutions and values, which are often deeply rooted. Particular forms of corporatist self-regulation may have great legitimacy in the Netherlands, but may be met with great hostility in the USA. As a result, the costs of such institutions may be much higher in the USA. This implies that there is not necessarily a 'one best way' to organise the economy for all times and all places. And also that it is not without problems to transplant American market solutions or Japan community allocation mechanisms to other societies (Van Waarden 1997, p. 13).

The core theme of this book is how the Dutch and German economies, variants of the Rhineland model, are changing and have to be changed, in the light of the above mentioned structural changes. To be more specific, the central question is: to what extent does the German and Dutch experience in this respect set an example for other (European) economies? Specific questions that will be addressed are:

- what are the advantages and disadvantages of the Rhineland model relative to the Anglo-Saxon model for structuring the economy?
- are the changes in the Netherlands an example for the necessary changes in the Federal Republic of Germany and other Member States of the European Union?
- will the increased internationalisation and the strife for integration in Europe result in a uniform structuring of the European economies?

In this chapter we summarise the major issues at stake when discussing the alleged controversy between state coordination and coordination by the market. Our point of departure is that no market can function without an appropriate institutional setting and that market institutions and regulations or government interventions are not simply sources of inertia and resistance to adaptation; they may actually act as the very vehicles for innovation and change. Neoclassical economists are inclined to perceive only the costs of regulation; intervention
disrupts the 'natural' order and impedes an optimal allocation. However, regulations also have functions and benefits, which become particularly apparent in the history of regulation. Many regulations, institutions and conventions, as they still exist at present in the Dutch economy, have been 'created' in the first half of this century. Their aim was to correct or mitigate the coordination failures, monopolistic practices and inequalities in the distribution of income and wealth connected with the free functioning of markets (see Kuipers 1996). In this sense states and markets are complementary, not substitutes (Rodrik 1996; 1997).

A relevant question is which institutions, arrangements and structures are better suited to perform their task within the changing international scene and various other developments mentioned above. Before this question can be answered we need:
1. insight in the differences in economic performance between countries;
2. insight in the institutional differences between countries, and;
3. insight in the role institutions and conventions play in market economies, i.e. why institutions exist in the labour, goods and financial markets.

This chapter is organised as follows. In Section 1.2 the major common trends in the industrial economies are discussed to illustrate the relevance of a comparison of the German and Dutch economies. In Section 1.3 a number of stylised facts are presented. A comparison is made of the social-economic performance of Germany and the Netherlands. The Unites States and the United Kingdom, representatives of the Anglo-Saxon model, are used as benchmark countries. In the 1970s and 1980s the German variant of the Rhineland model, the so-called 'Soziale Marktwirtschaft' was seen as a role model. During the 1990s the Dutch version, the 'Delta model', increased considerably. This shift in appreciation from the 'Soziale Marktwirtschaft' to the 'Delta model' as an example for other EU Member States is reviewed in Section 1.4. Section 1.5 discusses the theory and practice of the relationship between institutions and conventions and the performance of labour markets, financial markets, and product markets. Section 1.6 concludes and gives a summary of the contents and structure of the book.

1.2 Common Trends and Problems

As a result of the decline in the birth rate and the increase in the number of older persons, the proportion of persons employed will decrease in relation to the proportion of persons out of the labour force. Given the assumptions about

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2 Note, however, that political scientists and lawyers often start from opposing assumptions: the 'natural' societal condition is one of chaos, destruction, insecurity, and an unlimited and all-destructive battle of all against all (Van Waarden 1997, p. 17).
fertility, life expectancies and immigration flows, the old-age dependency ratio is expected to increase sharply between 1990 and 2040, although the pace of ageing differs across OECD countries (see Figure 1.1). From around 20% in 1990 for most industrial countries, the ratios will be more than doubled to almost 50% in the Netherlands and Germany, and be almost doubled by the year 2040 in the USA to almost 35%. A strong ageing is projected for the Netherlands; starting with one of the lowest ratios in 1990 and reaching one of the highest in 2040. The opposite holds for the UK: while it started in 1990 at a relative advanced level, population ageing is projected to be less pronounced. Beyond 2040 the elderly dependency ratios are projected to decrease in all countries. The demographic developments – the double ageing process – will have important social and economic consequences for all OECD countries. These developments will put great stress on the systems of social security, pensions systems and health care of the industrial countries. In particular, higher pensions and social security premiums (wedge) will profoundly affect labour markets. Moreover, the need to transfer an increasing amount of resources to the elderly will have major consequences for the intergenerational distribution of welfare. Furthermore, growing pension funds are likely to substantially impact financial markets. At the same time increased life expectancy offers opportunities to extend productive working life (see Delsen and Reday-Mulvey 1996; European Economy, nr. 3, 1996; OECD 1994a; World Bank 1994). All industrial countries have to cope with these challenges and opportunities posed by these demographic trends.

**Figure 1.1** Old-age dependency ratios, 1990-2050

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3 Defined as population aged 65 and over as a percentage of the population of working age, i.e. those between 15 and 64. The latter have to support the former through their employment and the income they generate.
The reduction in the transport and communications costs and the abolishment of legal barriers to international transactions (such as taxes) imply that to a large extent economic activities have become foot-loose. The cross-border flows of capital and the exchange of technology have increased markedly over the past decades. Also the international trade in goods and services shows an increasing trend. It is often referred to as 'globalisation' (Vernon 1996). However, the internationalisation of the economies is not global, in fact internationalisation is mainly regionalisation (see for instance Krugman 1991; Kleinknecht and Ter Wengel, 1996). As in social life also in economic life there seems to be much truth in the saying that “a near neighbour is better than a distant cousin”. This is increasingly becoming relevant for European economies.

Figure 1.2 Intra EU Foreign Direct Investment, European Union 12, 1982-1993


The regionalisation process can be shown by the evolution of the flows of the foreign direct investment (FDI) for the EU-12 (see Figure 1.2). During the period 1982-1993, the share of outward FDI that was directed to other EU countries and the share of inward FDI that originated from other EU-12 countries increased sharply. EU countries have accounted for an increasing share of a rising total of inward and outward FDI in the EU (see Van Aarle 1996).

For Europe the changing international trade patterns show that the intra-European trade has grown much faster than the extra-European trade. Extra-European trade has remained broadly stable as a share of Gross Domestic Product (GDP)
since the early 1960s, at around 5%, while intra-European trade soared from 10% to 15% of GDP in the same period (Van den Noord 1996, p. 208). During the 1980-1995 period the import and export shares of the EU-12 economies remained relatively constant, fluctuating around a level of 21 to 26% of GDP. However, more importantly, the share of intra-EU exports and intra-EU imports rose from 50% to over 60% in this period (see Figure 1.3). With more or less constant import- and export-to-GDP ratios, the increasing shares of intra-EU trade imply trade diversion/substitution from extra-EU trade towards intra-EU trade (Van Aarle 1996, p. 129).

Figure 1.3 Intra EU import and export, European Union 12, 1980-1995

The German and Dutch economies are no exception to the rule. Germany, by far the largest importer and exporter of the EU, also experienced an increase in the share of its intra-EU trade from 50% to 55% between 1980 and 1994 (Van Aarle 1996, p. 131). In 1995 almost 57% of German total exports was to EU countries and over 54% of all imports was from EU member countries, while both the import and export shares for other regions are below 10% (OECD 1996a, p. 9). For the Netherlands the data show a similar picture. However, the shares of intra-EU exports exceed intra-EU imports considerably. Between 1982 and 1994 the proportion of Dutch intra-EU exports in all Dutch exports increased from around 74% to around 78%. In the same period the share of intra-EU imports in all Dutch imports increased from around 56% to around 62% (see Van Aarle 1996, pp. 130-131; Jochemsen, Chapter 6 in this volume). Exports to and imports from Germany account for over one-third of Dutch intra-EU trade (OECD 1996b; CPB 1995, p. 95).
The data in this section not only show an increasing interdependency of regional (=European) economies and the common problems industrial countries face, they also show the economic importance of Germany and the Netherlands as good neighbours in the European Union and hence the relevancy of comparing the German and Dutch economies. In the next section some international comparative data on the German and Dutch social-economic performance are presented.

1.3 Some Stylised Facts on Economic Performance

In order to obtain a first impression of the strengths and weaknesses of the Anglo-Saxon and Rhineland models we describe the performance of two representatives of each of these models: the United Kingdom and the United States of America on the Anglo-Saxon side and the Federal Republic of Germany and the Netherlands on the Rhineland-side. The economic performance of these countries is considered for the period 1973-1996. In 1973 the industrial countries were hit by the first oil-shock. Three subperiods are selected, namely, 1973-1982, 1983-1990 and 1991-now (1995 or 1996). The dividing lines of these subperiods are the recession at the beginning of the 1980s and the unification of Germany in 1990. The indicators used for describing the economic performance of the economies can be divided into four groups. Those of the first group measure the macroeconomic performance. The second and third group of indicators focus on a particular sector of the economy, namely the labour market and the government. The fourth and last group broadens the view to social factors.

Table 1.1 Gross domestic product (GDP), 1976-1995 (annual percentage changes)

<table>
<thead>
<tr>
<th></th>
<th>Germany</th>
<th>Netherlands</th>
<th>United Kingdom</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td>1976-1996</td>
<td>2.5</td>
<td>2.3</td>
<td>2.1</td>
<td>2.7</td>
</tr>
<tr>
<td>1976-1982</td>
<td>2.3</td>
<td>1.6</td>
<td>1.4</td>
<td>2.3</td>
</tr>
<tr>
<td>1983-1990</td>
<td>3.0</td>
<td>3.0</td>
<td>3.3</td>
<td>3.3</td>
</tr>
<tr>
<td>1991-1995</td>
<td>2.2</td>
<td>2.1</td>
<td>1.3</td>
<td>2.2</td>
</tr>
</tbody>
</table>

Source: Central Planning Bureau (CPB), The Hague; own calculations.

An often used indicator of macroeconomic performance is the growth of Gross Domestic Product (GDP), which measures total production. During the last two decades the annual growth rate of GDP was the highest in the USA and the lowest in the UK (see Table 1.1). The differences between the four countries are small. More striking is that for the UK the differences between the periods are
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relatively large. In the second half of the 1980s the annual growth rate in the UK is one of the highest, in the other two subperiods it is clearly the lowest.

| Table 1.2 Output per person, 1973-1996 (annual percentage changes) |
|-----------------|-----------------|-----------------|-----------------|
| Germany         | 3.1             | 1.1             |
| Netherlands     | 2.6             | 1.6             |
| United Kingdom  | 1.5             | 1.9             |
| United States   | 0.3             | 0.8             |


A disadvantage of GDP as a performance indicator is that it does not relate the output to the input that is required for producing the output: a high growth rate of GDP might have required a lot of effort. Hence a measure of economic efficiency is needed. Only those increases in GDP unambiguously imply a better performance (in terms of increased efficiency) which follow from investment in more effective machinery, a more skilled labour force, better organisation of production or from increased opportunities for work for a previous excluded section of the population (Glyn and Miliband 1994, p. 10). Increase in efficiency could also be achieved in the form of shorter hours of work or less intensive working conditions, in which case GDP does not rise. In Table 1.2 output per person is used as a measure for economic efficiency. During the entire period the annual growth in output per person is in the two Rhineland-countries higher than in the two Anglo-Saxon countries. For the second period, however, the British figure is the highest. A reason for the low growth rate for the USA can be the high level of productivity in the USA (see Schmid and Helmer, Chapter 3 in this volume).

The number of people employed, the productivity per worker and trends in their real earnings will be key elements in coping with the increases in expenditure on social programmes due to demographic ageing. Moreover, a high number of inactive people leads to social costs in terms of social exclusion causing an increased probability of criminal actions. From an economic point of view inactive people loose their skills and thus inactivity leads to a loss of human capital. The unemployment rate gives a first impression of the level of inactivity. For the entire period the average unemployment rate is lower in the Rhineland countries than in the two Anglo-Saxon countries (see Table 1.3 row 1). Up to the beginning of the 1970s the German unemployment rate is the lowest, thereafter it increased so that during the last subperiod the Netherlands and the United States surpassed Germany. Except for the subperiod 1973-1982, the unemployment rate in the UK has been the highest of the countries concerned (see Table
Table 1.3 Unemployment rate, inflation rate and misery-index, 1973-1995

<table>
<thead>
<tr>
<th></th>
<th>Germany</th>
<th>Netherlands</th>
<th>United Kingdom</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>mean</td>
<td>st. dev.</td>
<td>mean</td>
<td>st. dev.</td>
</tr>
<tr>
<td>A Unemployment rate</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1973-1995</td>
<td>5.1</td>
<td>2.1</td>
<td>7.3</td>
<td>2.7</td>
</tr>
<tr>
<td>1973-1982</td>
<td>3.3</td>
<td>1.4</td>
<td>5.8</td>
<td>2.6</td>
</tr>
<tr>
<td>1983-1990</td>
<td>6.4</td>
<td>0.9</td>
<td>9.9</td>
<td>1.6</td>
</tr>
<tr>
<td>1991-1995</td>
<td>6.7</td>
<td>2.0</td>
<td>6.4</td>
<td>0.6</td>
</tr>
<tr>
<td>B Inflation rate</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1973-1996</td>
<td>3.6</td>
<td>1.9</td>
<td>4.2</td>
<td>3.1</td>
</tr>
<tr>
<td>1973-1982</td>
<td>5.2</td>
<td>1.4</td>
<td>7.1</td>
<td>2.1</td>
</tr>
<tr>
<td>1983-1990</td>
<td>1.8</td>
<td>1.2</td>
<td>1.5</td>
<td>1.4</td>
</tr>
<tr>
<td>1991-1996</td>
<td>3.3</td>
<td>0.9</td>
<td>2.7</td>
<td>0.5</td>
</tr>
<tr>
<td>C Misery index</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1973-1995</td>
<td>8.7</td>
<td>1.7</td>
<td>11.5</td>
<td>2.7</td>
</tr>
<tr>
<td>1973-1982</td>
<td>8.5</td>
<td>1.5</td>
<td>12.8</td>
<td>2.7</td>
</tr>
<tr>
<td>1983-1990</td>
<td>8.2</td>
<td>1.6</td>
<td>11.4</td>
<td>2.5</td>
</tr>
<tr>
<td>1991-1995</td>
<td>9.9</td>
<td>1.8</td>
<td>9.1</td>
<td>0.7</td>
</tr>
</tbody>
</table>


1.3, Part A). In the United States the unemployment rate has been remarkably stable at a level of about 6%. A striking difference between the USA and the other countries is that the unemployment rate in the USA was not effected by the first oil shock, whereas in the European countries this shock led to a significantly higher unemployment rate. In all countries the unemployment rate was at its highest level in 1983. From then the Dutch rate declined gradually and became lower than the German rate in 1992. Only in 1995 the British unemployment rate was lower than the German one.

Besides the level of macroeconomic activity its stability is important too. There are at least two reasons for considering stability. Firstly, risk-averse agents put value to stability as such. Secondly, it is generally believed that a stable economic environment will enhance economic growth. Stability increases the predictability of future developments and thus lengthens the time horizon of investors, so that they are more inclined to invest in projects for which the payback period is relatively long. In general these are projects which require much Research and Development, are relatively risky, and have a relatively large profit potential. A high inflation rate is the most important macroeconomic phenomenon that points at an unstable situation. The inflation rate of the Rhineland countries is almost always lower than that in the Anglo-Saxon countries (see Table 1.3, Part B). The German inflation rate is the lowest, except for the years 1991-1996. This tempo-
rary worsening of the German performance can be ascribed to the unification. The British inflation rate is the highest; also its variability is relatively large. In all four countries, the standard deviations show a decreasing trend, indicating a reduction in the variability of the yearly inflation rates and a more stable situation in each subperiod.

The *misery index* is the sum of the unemployment rate and the inflation rate. This index is inspired by the Phillips-curve trade-off between inflation and unemployment. Moreover, the misery index can be regarded as measuring both the level of economic activity and its stability. Once again Germany and the Netherlands appear to have performed better than the UK and the USA (Table 1.3, Part C). Both the mean and standard deviation of the misery index of the two continental European countries is lower than those of the two Anglo-Saxon nations. Until 1992 the misery index in Germany is the lowest, thereafter the index of the Netherlands and the USA (1994 and 1995) are lower. Overall the UK shows the worst performance. From the figures on economic growth, unemployment and inflation we conclude that in general the Rhineland countries have performed better than the two Anglo-Saxon countries. In many respects the macroeconomic performance of the British economy is the worst.

**Table 1.4** Ratio of employed to total population and working age population in 1992

<table>
<thead>
<tr>
<th></th>
<th>Total population</th>
<th>Working age population</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>44.9</td>
<td>64.9</td>
</tr>
<tr>
<td>Netherlands</td>
<td>43.8</td>
<td>64.2</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>44.0</td>
<td>67.8</td>
</tr>
<tr>
<td>United States</td>
<td>46.6</td>
<td>71.1</td>
</tr>
</tbody>
</table>

*Source:* Maddison 1995, p. 244.

The unemployment rate gives an incomplete picture of the level of inactivity in an economy. Other types of inactivity such as sickness, disability and early retirement are not included in the unemployment rate. In order to capture these forms of inactivity we relate the number of *employed people* to the total population and the potential working force (those between 15 and 64). According to both measures in 1992 the level of inactivity in the USA was lower than that in the other three countries (see Table 1.4). The difference between the USA and the other three countries is the greatest for the share of the number of employed persons as a percentage of the working force. This figure is relatively low in the Rhineland countries, whereas in the UK it is intermediate.
The functioning of the labour market appears to be of crucial importance for the performance of an economy. Therefore, in this book three chapters (Chapters 2-4) are devoted to the labour market. In this introduction we pay attention to some characteristics of the labour market. As stated above, a high level of inactivity will lead to a loss of skills and thus to a decline in human capital. In this respect it is not only the level of unemployment that is relevant but also (and maybe to a greater extent) the duration of the inactivity. There appears to be a great difference between the USA and the European countries. In the USA long-term unemployment is significantly lower than in Europe (see Table 1.5). During the last decades in Germany the proportion of long-term unemployment (12 months and over) in total unemployment has steadily increased, whereas in the Netherlands this proportion gradually decreased and was at the same level as in the UK in 1995. So with respect to long-term unemployment the same conclusion can be drawn as with respect to the unemployment rate; the main difference is not that between the two economic systems but between Europe and the United States.

Table 1.6 Unit labour costs, 1976-1996 (annual percentage changes)

<table>
<thead>
<tr>
<th></th>
<th>Germany</th>
<th>Netherlands</th>
<th>United Kingdom</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td>1976-1996</td>
<td>3.3</td>
<td>0.9</td>
<td>6.1</td>
<td>3.6</td>
</tr>
<tr>
<td>1976-1982</td>
<td>4.9</td>
<td>2.8</td>
<td>12.9</td>
<td>8.3</td>
</tr>
<tr>
<td>1983-1990</td>
<td>2.1</td>
<td>-0.6</td>
<td>3.4</td>
<td>1.2</td>
</tr>
<tr>
<td>1991-1996</td>
<td>3.2</td>
<td>0.6</td>
<td>2.0</td>
<td>1.3</td>
</tr>
</tbody>
</table>


Wage increases corrected for changes in labour productivity are important determinants of employment. During all subperiods the changes in the Dutch unit
labour costs were the lowest (see Table 1.6), indicating an improvement of the competitive position of the Netherlands on world markets. In the second half of the 1980s the Dutch wage increases were even smaller than the improvements in labour productivity. With an annual rate of 6.1% the increases in the unit labour costs in the UK were the highest. Especially in the period before the Thatcher administration the wage increases were very high, but also in the years after 1982 the annual changes in British unit labour costs were higher than those in the other countries. During the last two decades the rise in unit labour costs in Germany and the USA was approximately the same. In the 1970s, the German rates were lower than those in the USA, whereas from 1983 onwards the reverse holds. Once again the differences between the countries do not correspond with the two models of economic systems. In part the differences may be related to differences in the phases of the business cycle.

Table 1.7 General government: outlays and financial balances, 1978-1995/1996 (as a percentage of GDP)

<table>
<thead>
<tr>
<th></th>
<th>Germany</th>
<th>Netherlands</th>
<th>United Kingdom</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total outlays</td>
<td>1978-1995</td>
<td>47.9</td>
<td>55.7</td>
<td>42.5</td>
</tr>
<tr>
<td></td>
<td>1978-1982</td>
<td>48.0</td>
<td>54.9</td>
<td>42.8</td>
</tr>
<tr>
<td></td>
<td>1983-1990</td>
<td>46.4</td>
<td>56.4</td>
<td>41.6</td>
</tr>
<tr>
<td></td>
<td>1991-1995</td>
<td>50.3</td>
<td>55.3</td>
<td>43.5</td>
</tr>
<tr>
<td>Financial deficit</td>
<td>1973-1996</td>
<td>2.5</td>
<td>3.7</td>
<td>3.4</td>
</tr>
<tr>
<td></td>
<td>1973-1982</td>
<td>2.6</td>
<td>2.9</td>
<td>3.5</td>
</tr>
<tr>
<td></td>
<td>1983-1990</td>
<td>1.6</td>
<td>5.0</td>
<td>1.7</td>
</tr>
<tr>
<td></td>
<td>1991-1996</td>
<td>3.2</td>
<td>3.3</td>
<td>5.6</td>
</tr>
</tbody>
</table>

Source: Leibfritz et al. 1994, Table A6.

A striking difference between the Rhineland model and the Anglo-Saxon model concerns the role of the government. The market plays a dominant role in both models. However, in the Rhineland countries the institutional arrangements explicitly take into account the possibility of market failures. The government is supposed to create the circumstances under which the market process leads to outcomes that are just for all. In the Anglo-Saxon countries the results of the market process are accepted as such. Essentially, the government has almost no role in correcting these results. A consequence of this difference is that in general in the Rhineland countries government expenditures (as a percentage of GDP) are greater than in the Anglo-Saxon countries. The figures of total outlays of the government (central and local) affirm this statement (see Table 1.7).
ranking of the countries by the size of total outlays is: the Netherlands, Germany, the UK and the USA. Except that the total governmental expenditures in the Rhineland countries are higher than in the Anglo-Saxon countries, within each group the outlays of the more open economies are the greatest. This results corresponds with Rodrik (1996; 1997), who claims that countries that are more exposed to trade have a larger government sector because governments provide social insurance to counter the effects of exposure to external risk.

The financial deficits of the government are the highest in the Netherlands and the UK (see Table 1.7). A striking difference between these two countries is that during the 1990s the Dutch deficit declined, whereas the British increased. This increase can be ascribed to the recession in the UK during the first years of the 1990s. The German deficit was very low in the second half of the 1980s; it increased in the 1990s, due to the costs associated with the German re-unification. Mostly the deficits in the USA are lower than those in the other countries. From these figures no significant difference between the two models can be distinguished.

**Figure 1.4** Gross public debt (as a percentage of nominal gross domestic product), 1978-1995

![Graph showing gross public debt](image)

*Source:* Leibfritz et al. 1994, Table D8.

Also the data on the level of the debt show no significant difference between the Anglo-Saxon and Rhineland model (see Figure 1.4). From 1982 onwards the Dutch gross public debt (as a percentage of GDP) is the highest of the four countries. During that period one of the Anglo-Saxon countries occupies the second position. Until the beginning of the 1990s the German public debt was relatively low. From then onwards, it increased fastly; once again, due to the unification.
**Table 1.8** Gross domestic product and human development index, 1987, 1989 and 1993

<table>
<thead>
<tr>
<th>Year</th>
<th>Year</th>
<th>Real GDP per capita (PPP$)¹</th>
<th>HDI</th>
<th>GDP rank minus HDI rank²</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>1987</td>
<td>14 730</td>
<td>0.97</td>
<td>-1</td>
</tr>
<tr>
<td>1989</td>
<td>1989</td>
<td>14 507</td>
<td>0.96</td>
<td>-2</td>
</tr>
<tr>
<td>1993</td>
<td>1993</td>
<td>18 840</td>
<td>0.98</td>
<td>-2</td>
</tr>
<tr>
<td>1987</td>
<td>1987</td>
<td>12 661</td>
<td>0.98</td>
<td>10</td>
</tr>
<tr>
<td>1989</td>
<td>1989</td>
<td>13 351</td>
<td>0.97</td>
<td>8</td>
</tr>
<tr>
<td>1993</td>
<td>1993</td>
<td>17 340</td>
<td>0.94</td>
<td>18</td>
</tr>
<tr>
<td>1987</td>
<td>1987</td>
<td>12 270</td>
<td>0.97</td>
<td>8</td>
</tr>
<tr>
<td>1989</td>
<td>1989</td>
<td>13 732</td>
<td>0.96</td>
<td>11</td>
</tr>
<tr>
<td>1993</td>
<td>1993</td>
<td>17 230</td>
<td>0.92</td>
<td>7</td>
</tr>
<tr>
<td>1987</td>
<td>1987</td>
<td>17 615</td>
<td>0.96</td>
<td>-17</td>
</tr>
<tr>
<td>1989</td>
<td>1989</td>
<td>20 998</td>
<td>0.98</td>
<td>2</td>
</tr>
<tr>
<td>1993</td>
<td>1993</td>
<td>24 680</td>
<td>0.94</td>
<td>0</td>
</tr>
</tbody>
</table>

¹ PPP$ = Purchasing Power Parity, US dollar.
² A positive figure indicates that the HDI rank is higher than the GDP rank, a negative the opposite.


Hitherto we have compared various economic indicators of the four countries. However, an assessment of the social-economic order based on economic factors only, misses the greater part of the social component. We therefore conclude this section with a comparison of the four countries with regard to the Human Development Index (HDI) and the income distribution. The HDI is developed by the United Nations in order to incorporate in one index economic growth as well as some other factors which are relevant for the development of countries. The HDI contains measures of the life expectancy at birth, the adult literacy rate and the real GDP per capita (see UN 1990, p. 109 for details). The differences between the HDI of the four countries concerned are small (see Table 1.8). In 1987 and 1993 this index was higher for the Rhineland countries, whereas in 1989 the Anglo-Saxon countries had a slightly higher index. The real GDP per capita is the highest in the USA (see Table 1.8). Except for 1987, the ranking of the USA according to the HDI roughly corresponds with the ranking resulting from the GDP per capita. For Germany the difference in ranking resulting from the use of the HDI or the GDP per capita are always small. The rank of the other two countries is always higher when the HDI is used than when use is made of the GDP measure. Once again the United Kingdom shows the worst performance.
Table 1.9 Income distribution. Percentage share of income

<table>
<thead>
<tr>
<th>Year</th>
<th>Lowest 20 percent</th>
<th>Second quintile</th>
<th>Third quintile</th>
<th>Fourth quintile</th>
<th>Highest 20 percent</th>
<th>Highest 10 percent</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>1974</td>
<td>6.9</td>
<td>11.0</td>
<td>15.4</td>
<td>21.9</td>
<td>44.8</td>
</tr>
<tr>
<td></td>
<td>1978</td>
<td>7.9</td>
<td>12.5</td>
<td>17.0</td>
<td>23.1</td>
<td>39.5</td>
</tr>
<tr>
<td></td>
<td>1988</td>
<td>7.0</td>
<td>11.8</td>
<td>17.1</td>
<td>23.9</td>
<td>40.3</td>
</tr>
<tr>
<td>Netherlands</td>
<td>1977</td>
<td>8.1</td>
<td>13.7</td>
<td>17.9</td>
<td>23.3</td>
<td>37.0</td>
</tr>
<tr>
<td></td>
<td>1981</td>
<td>8.3</td>
<td>14.1</td>
<td>18.2</td>
<td>23.2</td>
<td>36.2</td>
</tr>
<tr>
<td></td>
<td>1988</td>
<td>8.2</td>
<td>13.1</td>
<td>18.1</td>
<td>23.7</td>
<td>36.9</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>1979</td>
<td>7.3</td>
<td>12.4</td>
<td>17.7</td>
<td>23.4</td>
<td>39.2</td>
</tr>
<tr>
<td></td>
<td>1988</td>
<td>4.6</td>
<td>10.0</td>
<td>16.8</td>
<td>24.3</td>
<td>44.3</td>
</tr>
<tr>
<td>United States</td>
<td>1972</td>
<td>4.5</td>
<td>10.7</td>
<td>17.3</td>
<td>24.7</td>
<td>42.8</td>
</tr>
<tr>
<td></td>
<td>1980</td>
<td>5.3</td>
<td>11.9</td>
<td>17.9</td>
<td>25.0</td>
<td>39.9</td>
</tr>
<tr>
<td></td>
<td>1985</td>
<td>4.7</td>
<td>11.0</td>
<td>17.4</td>
<td>25.0</td>
<td>41.9</td>
</tr>
</tbody>
</table>


Figures on the income distribution are only available for the 1970s and the 1980s (see Table 1.9). According to these figures the share of the lowest 20% of households in the income is the highest in the Netherlands and the lowest in the USA. In Germany, the Netherlands and the USA the share of the lowest 20% is relatively constant. During the 1980s in the United Kingdom this share declined from 7.3% to 4.6%, whereas that of the highest 10% increased from 23.8% to 27.8%. Hence, the income distribution has become more uneven in the UK. In both Germany and the USA the share of the highest income groups in total income has declined during these years. The changes in the income distribution in the Netherlands are small. Overall the income distribution is more equal in the Rhineland countries than in the two Anglo-Saxon countries.

The facts presented in this section suggest that during the last decades the economic performance of the UK has been worse than that of the three other countries. The USA perform better than the two Rhineland countries with respect to the annual growth of GDP, the level of employment and long-term unemployment. Moreover, the size of government expenditures and government deficit in the USA are lower than in the other countries. One of the two Rhineland countries outperforms the other countries with respect to the other criteria used. In every period in these countries income is more evenly distributed than in the Anglo-Saxon countries. During the last ten years the differences between the Rhineland countries and the USA have diminished with respect to the annual growth of GDP, the unemployment rate and the inflation rate. This may reflect that the American economy is more flexible and thus better able to react to the challenges of the structural changes discussed in Section 1.2. Within the group of Rhineland countries it also seems that the more flexible economy, that of the Netherlands, recently performs better than the German. This implies that the
German and Dutch economies have changed their relative position. In the next section we describe in more detail this change in rank and shed some light on the factors that have played in this respect.

1.4 From 'Soziale Marktwirtschaft' to the 'Delta Model'

In the 1970s and 1980s Germany for several reasons was seen as a role model. Hampden-Turner and Trompenaars, for example state “... who can doubt that it is the 'German model' that appeals most to the new Europe, rather than the American or Japanese models?” (Hampden-Turner and Trompenaars 1994, p. 201). Institutional arrangements of the German Federal Republic were considered as examples for building the European Union. Like Europe, the German states first drew together through the customs union ('Zollverein') with political union coming later. Germany exemplifies the federal decentralised structures most EU members wish to see on a European scale. The politically independent European Central Bank (ECB) is modeled on the German central bank, the Deutsche Bundesbank. The German-style capitalism is also the most important model for most ex-Communist countries. It is not simply closer geographically to the ex-Communist world than the Anglo-Saxon variant, but it is also closer psychologically and ideologically (Hampden-Turner and Trompenaars 1994, p. 202). The German model was associated with favourable economic performance in the 1970s and 1980s. At that time, as was shown in the previous Section 1.3, the growth rate was one of the highest, the increase in labour productivity was tremendous, the unemployment rate was low, the budget was under control, and debt was only 42-43% of GDP. These achievements have been attributed to institutional factors: the German 'Wirtschaftswunder' was thought to be the result of its 'soziale Marktwirtschaft'.

During the 1980s the German system of industrial relations was characterised by stability and adaptation and it was able to combine macro rigidity and micro flexibility. The German labour market relies more heavily on working time and internal flexibility than is the case in other EU countries. Trade unions and employers' associations, works councils and management have been able to cope with economic, technological and political changes, resulting in German industrial relations being among the most stable in the Western world. The German industrial relations have been presented as an enviable 'model' for other economies. Its huge economic successes have been attributed to its institutions: sectoral collective bargaining, labour law court, the independent Deutsche Bundesbank, the non-intervention in wage formation ('Tarifautonomie'), nationwide unions and employers' associations, works councils, dense local business networks and comprehensive training programmes. The German economy gained a comparative advantages in the 1980s by having a broadly skilled workforce and a well-developed system of education (see Den Broeder 1996; Visser and Van Ruysseveldt 1996; Soskice et al., Chapter 2 in this volume).
Inspired by the increase in unemployment rates, in the early 1990s the debate has shifted from 'Modell Deutschland' to 'Standort Deutschland'. Now the emphasis is on the costs of regulation, bureaucratic red tape, high labour standards, short and inflexible working hours and high non-wage labour costs (Visser 1996, p. 40). In the 1990s, the German model of industrial relations came under increased pressure, due to the poor performance of industry, and the social, economic and political problems which emerged after the unification (Paque 1993). Is Germany still attractive enough as a location for domestic capital and for foreign direct investment ('Standort Deutschland')? German employers and their associations complain that it is becoming increasingly difficult to compete against foreign companies because Germany has high wages, shorter working hours, long holidays, high tax rate and government red tape (EIIR February 1994; Visser and Van Ruysseveldt 1996, pp. 163-172).

In the 1970s and the first half of the 1980s the Netherlands were characterised by the so-called 'Dutch disease'. The increasing government resources (gas exploits) were used to stimulate the economy and employment through higher consumption and lower premiums. It resulted in wage and price hikes and an appreciating currency, which lead to a loss of competitiveness and jobs in the open sector. Moreover, the financial deficit increased sharply, from 1.4% in 1971 to 5.3% in 1979 and 9.4% in 1983. The governments consisting of a coalition of christian democrats, liberals and socialists were not able or willing to take significant measures. The radical change occurred in 1982. Then a coalition consisting of the christian democratic party and the liberal party won the elections. The resulting cabinet Lubbers-I introduced various austerity plans to reduce the budget deficit. Finally the succeeding cabinets under prime minister Lubbers succeeded in reducing the budget deficit and controlling the government debt. Meanwhile and maybe of even more important was that in the Autumn of 1982 the social partners (trade unions and employer organisations) concluded the 'Accord of Wassenaar'. This agreement forms the basis of a long period of moderate wage increases (see Table 1.6 in Section 1.3), which led to a sharp improvement of the Dutch competitiveness.

So at the start of the last decade of this century the Netherlands by and large had their public finances under control and were implementing measures to enhance the flexibility of the economy. Partly as a result of these measures, the Dutch economy outperformed that of Germany and many other EU Member States: the average growth rate of real GDP and employment growth were above average between 1989 and 1995. Early 1994 the standardised unemployment peaked and declined to 6.3% in 1996. It is one of the lowest among OECD countries and sharply below the EU average of 11% (OECD 1996b, p. 15). Also in monetary terms the Dutch economy performs well. The inflation rate is lower than those in partner countries and comparable with the traditionally low rate in Germany. Also employment growth has been considerable in the Netherlands, relative to other European countries, while in Germany employment dropped. For 1996 and 1997 employment growth is higher than in the USA. Moreover, labour productivity in the Netherlands is one of the highest in the OECD area (see
Schmid and Helmer, Chapter 3 in this volume). This good performance implies that for the Netherlands it is easy to fulfil the EMU convergence criteria, especially that of the budget deficit of less than 3% of GDP. Although the public debt level is still higher than 60% of GDP it is declining and therefore the Netherlands also meet this criterium (see Jochimsen, Chapter 6 in this volume).

The "Dutch model", including the constructive role of the trade unions and the extraordinary growth of part-time work is considered as an example by Belgian, French and German politicians and employers. Also central bankers consider the Dutch approach a success and the reforms of the institutional structure over the past few years are praised. Hans Tietmeyer, president of the Bundesbank, Jean-Claude Trichet, president of the Banque de France, William McDonough of the Federal Reserve Bank of New York and IMF-Director Michel Camdessus have recently praised the adaptability of the Dutch model. The Dutch model is labelled "Delta model" referring to the symbol of change and to the Rhine delta. The EU-partners envy the Dutch employment growth and the developments in government finance. The trade unions are very cooperative. Dutch moderate wage increases are presented as a cure for Europe's unemployment and as an alternative for the Anglo-Saxon model (*The Economist* 5 April 1997, p. 20). The Netherlands – the pink Kok administration – are considered a political synthesis of the Rhinelandic social market economy and the Anglo-Saxon market model. In the labour market the Dutch have tried to combine the flexibility of the United States of America with the security of Germany (Den Broeder 1996). The Dutch example seems to suggest that adjustment of the labour market and the social security system can have positive results for job growth without sharply increasing social inequality, as in the United Kingdom, and serious social unrest, as in France. The Netherlands show that change is achievable without wrecking the European 'social model'. Hence the Dutch experience shows that welfare states are flexible enough to adapt to new circumstances (see also Van de Meerendonk, Chapter 4 in this volume). Moreover, the Netherlands, seem to prove that meeting the EMU convergence criteria can go along with social policy and dramatic job growth (see also Schmid and Helmer, Chapter 3 in this volume).

Of course the differences in economic performance of Germany and the Netherlands, and the change from the *soziale Marktwirtschaft* to the Delta model becoming the role model can be partly explained by the asymmetric shock of the German re-unification. There is no doubt that from 1990s onwards in Germany the problems increased sharply. Section 1.3 showed that the unemployment rate increased and the share of long-term unemployment rose. The share of public spending in the GDP, the budget deficit and the increase in public debt can all three be ascribed to the unification of Germany. Another and maybe even more

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important explanation can be that, the differences between the two countries could be related to differences in culture and institutions. In this book the contributors concentrate on the latter. Differences between countries in the structure of labour markets, capital markets, and product markets are closely interlinked; together they form a cluster of complementary institutions. In the next section a brief review of the possible influences of norms, cultures and institutions on these three markets is presented. To some extent it provides the framework of the rest of this book.

1.5 Norms, Culture and Institutions and Economic Performance

1.5.1 Transaction Cost Theory and Institutional Economics

Neoclassical economics rely on open or simple “self-interest-seeking with candid disclosure”: the position of individuals is fully and candidly disclosed before trade takes place, there are no surprises (Williamson 1975, pp. 26-27; 1985, p. 49). In economic science, this neoclassical ‘perfect’ market is often used as a benchmark to relate actual market relations. A market is considered to be more flexible, and is considered more efficient, when it shows more resemblance with the ideal type of the free unregulated market. The neoclassical analysis focuses on production costs. According to the standard version of the neoclassical theory, in the long run, the market mechanism will result in an equilibrium between demand and supply on all markets. As far as in the short term no equilibrium is established, this is related to restrictions on the functioning of the market mechanism.

In institutional economics the focus is on the transaction costs, the costs of running the economic system. Old, new and neo institutional economics have in common the argument that information is not acquired costlessly or even immediately as assumed in the simple neoclassical competitive paradigm. These theories recognise that information is acquired through time, by experience, by the process of learning-by-doing and is less than perfect. This lack of information causes coordination problems. Transaction cost economics assume that human agents are subject to bounded rationality and are given to opportunism, which is a condition of “self-interest seeking with guile”. Individuals are “intendedly rational, but only limited so”: they are rational but up to the limit of their capacity to receive and process information. So it is not just merely a question of deficiencies of information that determine market outcomes but of deficiencies in the human capacity to process that information, this leads them either to develop norms of behaviour, rules of thumb, or to adhere to social conventions. Both represent ways of economising on the resources devoted to process any new information. The most critical dimension for describing transactions is the condition of asset specificity. Asset specificity refers to durable investments in transaction specific assets. Asset specificity arises in an intertemporal context. Implying that unlike neoclassical transactions exchanges are neither faceless nor
instantaneous (Williamson 1975, pp. 20ff; Williamson 1985, pp. 52-56). Specialised assets cannot be redeployed without sacrifice of productive value. One consequence of this is that long-term relations emerge in which contracting parties enjoy particular information advantages. 'Voice' rather than 'exit' is exercised to clear the market.

Incomplete information forces agents to act on predictions in case information is lacking, and extra information that makes predictions better enhances efficiency. Agents have to take care of coordinating their actions, by acting on their expectations of other agents. As these other agents act on their expectations as well, decisions become interdependent. In this way *multiple equilibria* may result, depending on the level of mutual expectations. Conventions and institutions have emerged to deal with these coordination failures\(^5\) (Van der Lecq 1996, p. 397). As prices are information carriers, institutions can be seen as complementary to prices: “Social and economic institutions are informational devices that supplement the informational content of economic systems when competitive prices do not carry sufficient information to totally decentralize and coordinate economic activities” (Schotter 1981, p. 109). In the case of information asymmetry parties may seek to exploit this information advantage and this may result in a lower level of efficiency. This has been described by Williamson (1975, p. 9; 1985, pp. 47-51) as “self-interest-seeking with guile” (opportunism resulting in behavioral *uncertainty*) and it is in order to obviate such behaviour, and to mitigate the associated inefficiencies, that in certain markets institutions, rules and norms of behaviour have emerged.

Depending on the type of problem, the norm takes the form of a convention or an institution. A convention is self-enforcing; an institution needs an enforcing authority such as a sanctioning mechanism to support it. It is noteworthy that the rules that are devised are often of a cooperative, rather than a competitive, form. The stable or self-enforcing systems of norms are a starting point for the explanation of institutional differences between countries. Rules and institutions by definition imply a certain amount of (price-wage)rigidity. However, these institutions and conventions may reduce the uncertainties associated with trade and promote economic growth. Hence, price and wage rigidities are not necessarily a symptom of insufficient operation of the market mechanism as supposed by neoclassical economics (Garretsen 1997). On the other hand too much reduction in risk and uncertainty may give rise to moral hazard. In situations of uncertainty, *beliefs* and *trust* become at least as important as knowledge. Institutions than can become carriers of these beliefs and are able to persist because they are believed to do so (Van Waarden 1997, p. 15 and p. 20).

How do the agents coordinate their actions in order to reach a particular outcome, i.e. what are the mechanisms behind the emergence, the selection and

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\(^5\) Coordination failures is said to be present if “mutual gains from an all-round change in strategies may not be realised because no individual player has an incentive to deviate from the initial equilibrium” (Cooper and John 1988, p. 442).
the persistence of rules, conventions and norms? In the emergence of norms the above mentioned interaction and reciprocal expectations play a crucial role, because the pay-offs actions agents choose depend on the actions taken by other agents. Conventions as the solution to coordination problems both need a macro and a micro underpinning: the social context influences the individual decision and is influenced by it. Three focal points that contribute to orderly markets are: contextual features, rules of thumb and common habits (Van der Lecq 1996, pp. 408-410). Contextual features, imply that the focal points are endogenously determined by the problem configuration. Rules of thumb are determined outside the problem. Habits emerge if for several periods of time the past choices determine (partly) the actual ones. Repetition of a problem creates a tacit agreement on the choice of a particular solution. This path dependence implies that the existence of institutions not only depends on their efficiency or utility increasing effects, but on their existence in former times as well. A coordinating norm may change once the coordinating problem or its context has changed significantly. Learning can also be a source of change for institutions if agents learn of a substantially more efficient institution to perform a task. The same holds for a convention shift. Shared mental models form a culture or an ideology and this may contribute to the explanation of different institutional configurations in different countries (Van der Lecq 1996, pp. 420-421).

After this brief overview of theories on the role of institutions, in the next three subsections respectively the labour market, financial market and product market institutions in relation to economic performance will be discussed in some detail.

1.5.2 Labour Market Institutions and Performance

Neoclassical labour market theory not only presupposes a perfect market, which i.a. means that labour is homogeneous, i.e. that the productivity of each worker is equal. Hence discrimination on the labour market is non existent and unemployment is only a rationing problem depending on the level of the market wage: unemployment is randomly distributed over the suppliers of labour, and unemployment is essentially a disequilibrium phenomenon. According to this neoclassic view ‘rigidity’ in the price of labour, the quantity and quality of manpower and conditions of employment are the hindrance to the clearing of labour markets. However, in reality labour markets are not perfect, if only because labour is heterogeneous. Hence the probabilities of becoming unemployed, and to remain unemployed, are unequally distributed. Apart from the rationing problem there also is a distributional problem (see De Neubourg 1995; Delsen 1997). Given the heterogeneity of the labour force, left to itself the market tends to produce and reinforce inequalities – between those in and out of work, between strong and disadvantaged groups in the labour market, between regions and countries. Particularly vulnerable are the unskilled, older workers, disabled persons and minorities, especially in depressed regions. Non-intervention is likely to result in slower adjustment at higher social costs. This may explain why in the labour market
competition-restraining institutions and anti-competition practices are introduced to a greater extent than in other markets. This may result in above market clearing wages. However, collusion among workers may save on transaction costs by giving a 'voice' to the workforce, it may also foster more harmonious relations between workers and management in the pursuit of common goals and strengthen social consensus in the society at large (OECD 1994b, p. 52).

Apart from the reduction in transaction costs, recent labour market theories like search, contract, insider-outsider and efficiency wages theory give economic reasons why wages are inelastic and explain the existence of involuntary unemployment as an equilibrium phenomenon. According to these theories offering wages above the market clearing level may be advantageous for the employer. For instance, it offers the opportunity to select good external candidates and to reduce turnover costs. Higher real wages moreover offer more effort and commitment of the employees.

The most important labour market institutions are unions and collective wage bargaining, job security and unemployment benefits. Until recently, in line with neoclassical thinking, there was somewhat of a consensus among economists that labour market problems in Europe are caused by these institutions. 'Eurosclerosis', as it was dubbed, resulted from social policies, legislation and collective agreements, centralised bargaining, resulting in high benefits, dismissal protection and restrained wage competition. Unemployment benefits lower the incentive for job search and increase wage pressure by insiders. Minimum wages price the least skilled out of the market. Job security provisions and firing costs disturb the market process, deter hiring, thus reducing labour demand, reduce job mobility and hamper the economies ability to deal with uncertainty and structural change. The disincentive effects of the welfare system was considered a main cause for the high level of structural unemployment in Europe. High marginal and average tax rates (wedges) result in higher wages and are harmful for employment, reduce work effort or searching for work, reduce labour supply and result is less investments in human capital (see for instance OECD 1994b).

Recently more neutral or opposite conclusions are drawn in the literature. Deregulation of the labour market and decentralised wage bargaining may be at the expense of trust and commitment, or in general the social climate, the latter being a major source of good economic performance. The social climate is often excluded from economic analyses and overlooked by policy makers in reshaping the welfare states. Decentralisation may also result in non-competitive wage premia (Den Broeder 1996; Nyfer 1996). Countries which moved towards decentralisation or less coordination over the passed decade have experienced larger declines in the employment rate than countries which did not experience such decentralisation/uncoordination (OECD 1997, p. 83). There is evidence that in countries with less favourable social security benefits, because of the pressure of serious social consequences in case of redundancies (poverty) the necessary restructuring of enterprises is postponed. This resistance to change is analysed by Englander and Gurney (1994). When structured properly, the social security system may promote the willingness of people to take risks, resulting in a
positive relationship between equality and efficiency (see Van de Meerendonk, Chapter 4 in this volume). Other research shows that sectoral institutions of concertation provide for necessary collective goods such as a skilled labour force and collective research and development. They create a certain order and stability on markets and reduce risk and uncertainty, thus facilitating long-term investment. They reduce labour unrest, all resulting in high labour productivity and high product quality (see Van Waarden 1997, p. 24). In the *OECD Employment Outlook 1996* it is concluded that cutting benefits and reducing minimum wages may not be a solution to lower long-term unemployment, because of the high social costs.

Different institutional settings, like wage bargaining, legal minimum wage and unemployment benefits and other benefits, rates of unionisation, have an impact on the volume of low paid jobs. These institutional features may create wage floors and reduce earnings dispersion, particularly at the bottom of the income distribution. However there is no hard evidence that countries with relatively few low paid jobs have reached this at the expense of higher unemployment rates and lower employment for the weakest groups in the labour market (OECD 1996a, pp. 75-76). Based on endogenous growth models it may be argued that minimum wage legislation does not necessarily have negative consequences on economic performance. In fact, it can have positive effects on growth by inducing more human capital accumulation: a low demand for unskilled labour, induced by a minimum wage, may create an incentive for workers to accumulate human capital. Moreover, it is possible that a decrease in the minimum wage lowers the welfare of each agent in the economy (Cahuc and Michel 1996). See also Dolado et al. (1996) for similar arguments.

### 1.5.3 Financial Systems and Economic Performance

The financial sector is of great importance for economic activity and economic growth, for it links savers and investors and selects the projects that will be financed and carried out. As Stiglitz (1992, p. 161) puts it: “if capital is at the heart of capitalism, then well-functioning capital markets are at the heart of a well-functioning capitalist economy”. In a neoclassical world of perfect competitive markets and perfect information, the institutional structure of financial markets plays no role, i.e. the world could do without bonds and shares. However, in reality the financial structure is determined by economic factors and probably to an even greater extent, by non-economic factors, including culture and social norms (see Hoogduin and Huisman, Chapter 5 in this volume). Of interest is whether these differences in financial structure have an impact on the economic performance.

Related to national capital market systems three models can be distinguished. The *bank-based model* is characterised by close ties between banks and industry, concentration of company share ownership among small groups of shareholders, a relatively high proportion of debt capital in company financing and participation of banks in the shareholders' equity of business (Gelauff and Den Broeder
For instance in Germany and Denmark stock market development has been limited and banks play the most prominent role as providers of capital. The market-based model or Anglo-Saxon system is characterised by a strong separation of ownership and management, many small shareholders, a limited role for banks in risk-bearing corporate finance, highly developed stock markets, many suppliers of venture capital and almost no anti-take over measures. In the bank-based model with concentrated shareholders, there is more incentive to intervene and to exercise 'voice' rather than 'exit'. In the Latin model of the financial sector, the stock market is also relatively underdeveloped: many businesses are family-owned, financial holding companies and cross-participation are common, as are state owned companies. This system operates in countries like Belgium, France, Spain and Italy. The Dutch financial system can be considered as an example of an intermediate form between the bank-based system and the market-based system (see Hoogduin and Huisman, Chapter 5 in this volume).

To evaluate the performance of capital markets several indicators are used: private sector investment ratio; internal financing of investment by business; capital market possibilities for external financing and costs of capital. From the available comparative research results no clear cut differences in performance between the bank-based and the market-based system can be established (see Ministry of Economic Affairs 1995; Mayer 1996). However, this does not mean that there are no (still unobserved) differences in performance between the bank-based and market-based model.

There is an important interrelationship between the structure of financial and product markets. The willingness of financial institutions to finance investment is crucial for healthy competition in the product market. Financing of investment will typically require very patient investors. Short horizons can obviously constrain investment (OECD 1994b, p. 25). In the bank-based model, ownership remains concentrated and long-term relationships and commitment develop. In the Anglo-Saxon market-based system characterised by dispersed, anonymous shareholders it is difficult to sustain trust and commitment. Mayer (1996, p. 25) concludes that competition in the product market is generally associated with allocative and productive efficiency. Competition encourages the supply of goods and services at lowest costs and at prices which reflect the underlying costs of provision. He argues that this does not necessary apply to financial markets. Competition in the financial markets may undermine the development of long-term relationships between firms and financial institutions: the provision of rescue funding by banks may be discouraged. On the other hand, limitation of competition in financial markets may result in monopoly exploitation of borrowers.

1.5.4 Product Market Regulation and Performance

Apart from financial markets also properly-functioning product markets are essential for the adaptive and innovative capacity of an economy. If markets do
not function well, this leads to cost inefficiency, deterioration of quality, risk-avoidance and lack of innovative behaviour. It can also have negative effects on the role played by small and medium-sized enterprises in the creation of new jobs (Ministry of Economic Affairs 1995, p. 101). Although all OECD governments embrace the principle that product prices should be determined by market forces, public intervention often weakens the strength of competition in the product market. This may be at the expense of employment. In most OECD countries, including Germany and the Netherlands, general competition legislation prohibits competition restraining measures (prohibition system) or the abuse of market power (abuse system) (see OECD 1994b, p. 25; Gradus, Chapter 7 in this volume).

There is an interrelationship between the structure of product markets and the labour markets. Imperfect competition in the product market can lower employment when employers share rents with their workers and results in above market clearing wages. Establishing a competitive environment could improve job prospects by both eliminating wage premia and encouraging output expansion. Initially, increased competition may result in job losses due to the elimination of existing inefficiencies. Rents come about because competitors cannot enter and eliminate supernormal profits. It is not the actual entry that matters but the threat of entry, i.e. producers in contestable markets are unlikely to earn any rents (OECD 1994b, pp. 23-24).

Regulations are not only necessary to constitute markets. There are also specific ones needed to maintain markets and competition. Regulations have to correct for too little and too much competition, which both reduce the effectiveness of competition. In order to prevent competition from destroying itself, antitrust legislation is needed (see Van Waarden 1997, pp. 18-19). Too strict antitrust cartel legislation may have opposite effects. The rather tolerant Dutch cartel policy thus far allowed for moderate forms of horizontal cooperation between competitors. A ban on such cooperation may force them to replace horizontal cooperation by vertical cooperation, i.e. cartels by firm hierarchies. This is exactly what happened in the American history (Van Waarden 1997, p. 18). According to the OECD (1994b, p. 53) the most efficient way to reduce the distortionary effects of imperfect product market competition on labour market outcome is to remove the opportunity for producers to earn rents. This will require tough enforcement of general competition legislation; pervasive statutory entry barriers and public subsidies to producers will have to be critically reviewed. But the most effective anti-trust policy is to maintain and to encourage a multilateral trading system, and to expose domestic producers to the rigors of international competition.

Indeed, related to product markets it is of importance to distinguish the sheltered or domestic sector from the open sector. The competition in the sheltered branches of industry, notably services, and public utilities is low or even absent. Less importance is attached to controlling costs. It results in higher prices and reduces employment and growth in the economy as a whole. In the internationally exposed sectors of the economy, strong competition is ensured by
open markets and effectively enforced competition policy. Deregulation and competition policy are supposed to promote competition, resulting in a dynamic product market and more efficiency and prosperity.

There is evidence of harmful effects of limited competition in the product market. Various studies indicate a positive relationship between *flexibilisation and economic growth* (see Van Bergeijk and Haffner 1996; Koedijk and Kremers, 1996; Gradus, Chapter 7 in this volume for an overview). These analyses by means of general equilibrium models or the construction of indices for market regulation have in common that they start from a model in which more price flexibility is assumed to be better and full competition is the norm. Hence price rigidities have no benefits, only costs (see Garretsen 1997).

The impact of competition on *productivity* is likely to be more indirect. By allowing inefficiencies to persist, weak competition may affect productivity growth. A lack of competition may also put insufficient pressure on management to improve productivity performance and incorporate new technology. Pilat (1996) found support for the view that exposure to international competition promotes productivity growth: competition on the international market can contribute to cost minimalisation, but exports may also allow specialisation and economies to scale. Also a *dynamic product market*, as measured by entry rates, provides a positive contribution to productivity growth. High entry and exit rates ensure that only the best (and most productive) firms survive (see Nickell 1996). These analyses mainly focus on costs. Deregulation of the sheltered sector and more competition in this sector, may be at the expense of the quality of services. When endogenous growth factors are taken into account, competition reduces prosperity in the long run. The cheaper and expanding sheltered sector will result in a reallocation of production factors in the economy and a *crowding out* of the open, more innovative sector. At the macro level this implies less investments in Research and Development and other innovative activities, resulting in a drop of productivity. So, it is perhaps not market and dynamics but market or dynamics (Van de Klundert and Smulders 1997). Finally, a dynamic product market may not always contribute to productivity growth as supposed by neoclassical economists. For instance, where market entry and exit is easy, because of little investment needed, there may be a permanent overcapacity in the market. The high turnover of firms and the low profit rates may imply that such firms lack the continuity needed for long-term investment and creative innovation. In that case, regulation may be needed to protect the product markets from too much competition (Cf. Van Waarden 1997, pp. 18-19).

1.5.5 Culture and Performance

From previous sections it is clear that countries with similar market institutions may perform differently, and countries with different institutions may perform similarly. To a large extent this may be related to differences in culture, for institutions for their effectiveness depend on cultural values in societies (Cf. Van Waarden 1997, p. 13). Until recently, economics has confined itself to a study
of transactions – how people utilise money, not why they do this or what there motives might be and lost sight of the one component, almost unmeasurable, that makes all economic activities possible: human relations. Behind every economic transaction are people making choices, acting on their values, given one thing high priority, another one low. Each culture brings a unique set of values to bear upon the act of wealth creation. These values characterise both the organisation that practises them and the products and services the enterprise creates (see Hampden-Turner and Trompenaars 1994, pp. 5-6).

Although neglected for a long time, increasingly economists consider norms and values as an ingredient in explaining differences between countries in economic performance. Economic life cannot be divorced from cultural life. The degree to which people value work over leisure, their respect for education, attitudes towards family, and the degree of trust they show towards their fellows all have a direct impact on economic life and yet cannot be adequately explained in terms of economists' basic model of man. Societies can save substantially on transaction costs because economic agents trust one another in their interaction and therefore can be more efficient than low-trust societies, which require detailed contracts and enforcement mechanisms. This trust is not the consequence of rational calculation; it arises from sources like religion or ethic habit (Fukuyama 1996, pp. 351-352). Trust may not be truly exogenous; it may increase with good past performance of a society's institutions (see La Porta et al. 1997). Based on World Values Survey data, Nyfer (1996) concludes that there are differences in the character of trust between Anglo-Saxon countries and continental Europe. In the European capitalism trust is based on personal relations build up over the years. In the more liberal market economies of the Anglo-Saxon countries the market parties base their trust on objective criteria like annual reports. There is a significant positive relationship between trust and average annual real growth of GDP per capita (Nyfer 1996).

Whether people trust their government and institutions like an independent central bank or a strong currency largely depends on social-cultural factors. Persons who disregard these European cultural differences may draw the wrong conclusions related to the potential of economic and political integration (Fukuyama 1996, p. 355). He considers social capital critical to prosperity and to competitiveness. Social capital is the ability of people to work together for common purposes in groups and organisations. In addition to skills and knowledge, a distinct portion of human capital has to do with people's ability to associate with each other, that is critical not only to economic life but to virtually every other aspect of social existence as well (Coleman 1988). The ability to associate depends, in turn, on the degree to which communities share norms and values and are able to subordinate individual interests to those of larger groups. Out of such shared values comes trust, and trust, has a large and measurable economic value (Fukuyama 1996, p. 10). Trust or social capital determines the performance of a society's institutions. The effects of trust on economic performance are statistically significant and quantitatively large. Based on the same World Value Survey data La Porta et al. 1997 show that trusts improves govern-
Institutions have both positive and negative effects on economic performance. The theoretical and empirical understanding of the roles played by institutions, norms and culture in the functioning of markets still is limited. It is the editors hope that this book contributes to a better understanding of the role played by institutions in economic life and to more balanced and better founded policy decisions related to the (re)structuring of our economies in response to the structural changes they are confronted with.

### 1.6 Contents and Structure of the Book

The book is divided into four parts. In the present chapter, Part One, an overview is given of the issues at stake when discussing the pretend controversy between state coordination and coordination by the market and a number of relevant issues in relation to comparing national economies, and it is shown why it is of interest to compare the German and Dutch economies in particular.

Part Two 'Institutional differences in the welfare states' consists of four chapters which focus on the differences in wage bargaining, labour market policies and labour market performance between the Netherlands and Germany and on the impact of the German and Dutch welfare states on economic performance. The UK and the USA are used as benchmark countries. Chapter 2 by David Soskice, Bob Hancké, Gunnar Trumbull and Anne Wren focuses on the German and Dutch wage bargain systems in relation to macroeconomic performance. They review the role of the different institutions of the German political economy and the problems in the German political economy and discuss the various solutions to these problems. The authors argue that a deregulation of the labour market according to the Anglo-Saxon example is not a viable long-term option for Germany. Next, the applicability Dutch model is discussed. They argue that despite the fact that Germany and the Netherlands show a number of relevant institutional similarities, the import of the Dutch political-economic model would destroy institutions that have long been the foundations of Germany's competitive advantages in the world market. Three additional solutions are discussed to increase corporate profitability without deregulating the German labour markets. These options include: a more expansionary macroeconomic policy, admitting wage dispersion and moderation of wages.

Chapter 3 by Günther Schmid and Maja Helmer deals with the Dutch employment miracle. In the 1980s, the Netherlands had one of the highest unemployment rates in the European Community; Germany one of the lowest. Today, the reverse is true. Is there a Dutch employment miracle? If so, how can it be
explained? This chapter tries to answer these questions in seven steps. Beginning with the development of an analytical framework within which to compare employment systems, the authors measure the performance of the two labour markets and economies, paying particular attention to the role of labour market policy in the process of adapting to structural change. It is shown that the Netherlands have an interesting, new configuration in which the advantages of competitive and coordinated capitalism are combined with a modernised form of the welfare state. A key shortcoming of both employment systems remains the hitherto highly passive character of employment redistribution. Transitional labour in markets would be a more appropriate strategy of redistributing employment in order to link long-term social needs and economic efficiency. On the whole, however, developments in the Netherlands point much more clearly than those in Germany to a path along which the European model could move.

In Chapter 4 Arthur van de Meerendonk analyses and compares the German and Dutch welfare states. A central issue in the chapter is the impact of the welfare state on economic performance, i.e. are there differences in economic performance between welfare states and liberal market economies? Two questions are addressed: to what extent are economic performances determined by welfare state institutions and are there differences in German and Dutch institutions that explain the current diverging economic performances of both economies? To examine these questions, Germany and the Netherlands are compared with the United States, the United Kingdom and Sweden. The current crisis in Germany in the aftermath of the unification reflects both internal and external causes. It is concluded that the internationalisation since the 1980s is not sufficient to explain the erosion of the German corporatist framework. Also the capacity of the government to act is crucial. The Dutch experience shows that corporatism can be altered, and that welfare state institutions can be reformed so as to contribute to the adjustment potential of the economy.

Part Three 'Financial and competition policies' includes three chapters which deal with the markets for goods and services and the financial markets in Germany and the Netherlands. The differences and similarities in the financial structure, monetary policy and competition policy are addressed. In Chapter 5 Lex Hoogduin and Henk Huisman discuss the differences and similarities of the financial structure in Germany and the Netherlands. The German financial system is a typical example of the continental 'bank-based' system, which is characterised by: risk-avoiding, co-operation, and long-term relationships between those who demand and those who supply capital. Although basically, the Dutch financial system is also 'bank-based', it contains more than the German system elements of the Anglo-Saxon 'market-based' financial system. The latter is characterised by risk taking, competition and short-term relations between the provider and user of capital. In the Netherlands there has always been a fairly open and relatively large stock market. Another difference is that in Germany the house-bank relationship between banks and firms are close and there is a widespread bank representation on the supervisory boards of firms. The third and final difference mentioned by the authors is the different way in which savings find their way to the capital market:
the Dutch save through pension funds and insurance companies, whereas the Germans save through banks. Despite these differences between the two countries, the similarities seem to be more important. Moreover both systems move towards a more Anglo-Saxon system. A major difference between the latter and the system in Germany and the Netherlands is that in the Anglo-Saxon countries changes in official interest rates have a comparatively greater impact on economic activity than in most continental European countries.

This brings us to monetary policy, the topic of Chapter 6 by Reimut Jochimsen. Since 1983 the guilder-Deutschmark rate is very stable. It is the only rate within the European Monetary System (EMS) which still has a narrow exchange rate band of 2.25%. The nominal interest rates in the two countries have converged. These developments reflect that the monetary authorities of the two countries aim at the same goal: a stable and low inflation rate. During the greater part of the last decades monetary policy is supported by healthy public finance and a wage policy which takes due account of the stability requirement. In the 1970s and the beginning of the 1980s, in the Netherlands both public finance and the wage policy were out of control. Since 1982 the scene changed significantly; Dutch wage increases are very modest and public deficit and debt are declining. Nowadays the German public finance is burdened by the costs of the unification and German wages are far higher than those in neighbouring countries. Moreover the Dutch have reformed the pension system and have taken deregulation measures. In Jochimsen's view in this respect the Germans can learn lessons from the Dutch. The tight relations between Germany and the Netherlands and the shared goal for stability can be regarded as a good example of the way the Economic and Monetary Union (EMU) might work. The great importance of Europe for both countries make that they once again are in the same boat: in the EMU the standard of stability should be guaranteed.

In Chapter 7, Raymond Gradus compares the Dutch and German competition policy. He states that Germany acts as the leader and the Netherlands as a follower with respect to all three fields of competition policy: competition law, privatisation and deregulation. Based on the prohibition principle, since 1958 the aim of the German competition policy is to safeguard competition. Since World War II Dutch competition policy on the other hand has been based on the abuse system. The onus of proof lies with the Minister of Economic Affairs and therefore, implementing competition policy is more difficult. However, the situation in the Netherlands has changed very dramatically in recent years. Recently the Dutch parliament has accepted a new law on competition policy, which is based on the prohibition system. The procedure in the new act has many similarities with the German practice. In fact, Dutch deregulation and privatisation policy has been based on current efforts in Germany. An interesting observation in this respect is that the Netherlands seems to put more effort into continuing its policy of deregulation than Germany. The chapter also discusses the macroeconomic consequences of this policy.

Part Four 'Concluding Remarks' contains one chapter, Chapter 8, in which the editors collect from the previous chapters the arguments for answering the
questions listed in Section 1.1. The following issues are dealt with. The pros and cons of the Anglo-Saxon and Rhineland model. The question whether the Netherlands is an example for the German economy. Finally the results of this book are used for answering the question whether the institutional arrangements in the European economies will converge toward one model and if so whether this model will contain more Anglo-Saxon elements than the present European economies.

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