

**Re-Thinking Approaches to Government Reforms**  
**OPI-Magdalen College Seminar Series**  
**Michaelmas Term 1999: Week Seven**

**An Economist Looks at Incentives for Public Sector Reform**  
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*In order to influence the policy-making process within a country, it is necessary to understand how public policy-making works. It differs in different countries. It is affected by the electoral system, by the structure of the political landscape, by the extent to which political power is centralised and by the political economy, in particular by the strength of corporate and trade union power. A comparison between the UK and Germany illustrates some of these differences. In the UK, centralised influence over policy is reinforced by an electoral system that allows the executive to muster support from a dominant parliamentary party and is barely contested by corporate or trade union dissent. As a result, unpopular policy reforms can be implemented with little effective resistance. In Germany, the Chancellor's influence over policy reform is limited by the need to develop a consensus between a coalition federal government, a partly politicised civil service with considerable influence, lander governments, well-organised trade unions and corporations that can co-operate easily to resist unpopular policy reforms. While this serves to disperse influence over public policy, the outcomes may not always be superior, as is illustrated by failure of the German biotechnology industry to keep pace with advances in the US and the UK.*

*How public policy is made*

The system for decision-making within the central government executive influences the policy-making process. The British system of public policy-making is highly centralised. Policy-making is driven from the centre: from the Prime Minister's Office (Downing Street) and from the Treasury. If a policy is promoted loudly and persistently enough during Cabinet meetings, and if that policy has the support of the Prime Minister and, especially, the Chancellor, then that policy can be imposed upon departments. In Germany, by comparison, the policy-making system is much less centralised. The *Ressort* (Ministry) Principle gives autonomy over policy-making to departments. Hence, civil servants (who, unlike in the UK, often have party allegiances) have a good deal of influence.

The structure of the party system in a country also affects policy outcomes. In Germany, policy options must be negotiated between, and agreed upon by, the ministries and the parties within a coalition government. Inter-party bargaining within the coalition weakens the ability of the Chancellor to impose policy. There are two other constraints on the policy-making power of the central government. First, there is a need to persuade influential business interests of the value of a particular policy. Secondly, there is a regional element: by the Constitution, the *Lander* (Provinces) must agree, either directly or through the regionally constituted Upper House of Parliament (the *Bundesrat*), to policies that directly affect them.

These constraints on the ability of the German government to impose policy are not found in the UK, where the electoral system tends to produce a compliant single party

parliamentary majority so that control over MPs by the central party hierarchy ensures that the executive can get its legislation through. Moreover, interest group representation is paid little attention in the UK. The government retains good relations with the CBI and the TUC, but those relationships are on the government's terms. Hence, the policy-making power of the Prime Minister and the core executive is much greater in Britain than in Germany, where the government is constrained by both internal and external forces.

### *Political Economies*

The political economies of Britain and Germany also differ. In Britain, companies find it difficult to co-operate over time and are therefore unable to solve public goods problems such as the provision of vocational training and internships. For the same reasons, they also find it difficult to mount effective opposition to unpopular policies. Furthermore, the disjointed nature of the corporate sector weakens the incentive for government to work with business to solve these problems.

In Germany, however, it is much easier for companies to co-operate over time. Information flows from individual businesses to business associations and these associations build up expertise. Many businesses have close links. For example the Research Directors of Hertspier and BASF have lunch together once a month. The main unions operate in a similarly co-operative way. This degree of co-operation and a culture of long term investment mean, for example, that large companies spend much more on training than they get from their trainee during the time of the apprenticeship. The long term perspective that applies in this case also applies in other situations of companies investing in risky goods, such as in research and development (see example below). Moreover, because German businesses play a long-term game, this co-operation is reinforced by a credible penalty for disobedience: punishment for the rest of the game. The close-knit structure of the German corporate and labour sectors also allows them to mobilise resistance to unpopular policy shifts. If government wants to make a change, it has to co-operate with unions or business associations.

The operation of the German political economy is illustrated by the example of attempts at labour market reform. The CDU government in Germany in the 1980s tried to mimic Mrs Thatcher's labour market reforms. However, business and the trade unions said that it would destroy the consensus they had developed; in particular, that a more flexible labour market would weaken the incentive for companies to invest in training apprentices.

One result of this long-term perspective is an industry-defined world. People are trained at an early age in a certain industry. Innovation takes place only within traditionally-defined industries; for example, engineering and chemicals. Thus, when problems arise within an industry, they can be resolved; but when a new industry comes along it is very difficult to establish that industry. The institutional structures do not exist.

The UK has a less coherent corporate sector and weaker links between government and industry. The first means that companies have less incentive to invest in training

staff in industry-wide skills, although companies do train staff in company-specific skills. The lack of an external monitoring system means that any industry-specific training is not always recognised by competitor companies, and there is not, therefore the same need for companies to protect their positions as there is in Germany. More emphasis is placed on more general transferable skills. On the other hand, since UK businesses invest less in institutional resources, they can take higher risks. If the project does not work, they can transfer their institutional resources into a new project. However, these high risks deter investment in industry-specific infrastructure. The result is a more flexible corporate sector but lower rate of investment in industry-specific R&D than in Germany. The weaker links between government and industry means that the correction of these market failures is more difficult and costly in the UK.

### *The example of biotechnology development*

Some of these differences explain why the biotechnology industry has developed much faster in the USA and the UK than in Germany. The German scientific research system has close links with business. A good scientist will have a high status career with a high profile company and will have strong links with private companies. For example, the leading Engineering Professor at Arken University has 315 assistants, 309 of which are funded by one of two companies. In order for professors to attract the best graduate students, they have to work on the fringes of big companies. These companies then fund top graduate students to do doctoral research on one of their problems. This source of funding means that there are very strong incentives for bright students to work within traditional industries (and therefore not, for example, in Biochemistry). Bright students who do want to work in Biochemistry are attracted to the USA by the funding available there.

Five years ago, German biotechnology companies set up research establishments in the USA. The need to establish primary biotechnology research within Germany became apparent. However this new industry only began to take root once a policy consensus had emerged:

1. that there was a need to offer stable careers to attract good students into biotechnology research (with the belief that the system in the USA was too risky);
2. that biotechnology was at an embryonic stage in its life-cycle so that the first stages of research would have highly unpredictable results;
3. that the long-term aim should be to build small and medium-sized research-based biotechnology companies to export, but also to feed into, larger German biotechnology companies.

The achievement of these aims required a long-term commitment from the government to invest in new biotechnologies, and also for effective research departments to be established within German universities. Public intervention of this kind would be required to overcome the problems of encouraging traditional companies in Germany to invest in new technologies by setting up separate, risk-taking companies while allowing traditional firms to apply the technologies once they had been developed.

## *Conclusions*

In Germany companies and trade unions have an incentive to invest in structures for co-operation where companies are all playing the same long-term game. However, this co-operation apparently slows down the rate at which innovations proceed. It can also make it difficult for the German government, already weakened by the need to negotiate with its coalition partners and by its constitutional duties to the *Lander*, to implement public sector reforms that are seen to be against the established interests of the companies and the trade unions.

In the UK, however, where the executive is powerful and can often command a unified legislative majority, and where co-operation between, and therefore the power of, business and the trade unions is small, it is much easier for the government to introduce controversial public sector reforms. On the other hand, although innovations can take hold more quickly in the UK than in Germany, investment is likely to be less than optimal and less committed to a long-term perspective. Moreover, the UK government faces more difficulty and higher costs in compensating for these market failures.

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