WHICH MODEL OF CAPITALISM?

Capitalism takes different forms, each with deep roots. What can we learn from the very different examples of Germany and the United States?

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Capitalism has won. The key question now is what type of capitalism will prevail? And what are the prospects for a new global model of capitalism, given the rapid globalisation of product and financial markets, and the emergence of new, more homogenous technologies?

Other processes are also forcing the pace of change. Increasing integration of world markets and the interdependence of national economies are leaving less and less room for idiosyncratic national institutions or economic policies, while liberalisation of trade and capital markets is widely seen as making further liberalisation of labour and social markets indispensable for countries who wish to remain competitive. On this view, OECD countries should be assessed on their readiness to accept necessary convergence on a dominant model of capitalism based on liberal economic principles. This article probes whether such wholesale convergence of capitalist models is really inevitable, or indeed desirable, by examining the reasons for past divergence and the continuing implications.

One key divergence relates to the level of social protection and the structure of labour markets. While most continental European countries have sought to retain generous welfare states and other key elements of their distinctive social models, Anglo-Saxon economies have favoured a more 'residual' welfare state, with reduced tax rates and flexible labour markets which incorporate high incentives to finding work. Such divergence is often characterised as depending primarily on different political conceptions of the appropriate trade-off between economic efficiency on the one hand, and social justice on the other – with liberal market, social market, or "third-way" conceptions offering different trade-offs. But, as this article will argue, the variation between national models also reflects wider differences of view as to how economic efficiency itself can be best achieved, depending in part on the different comparative advantages of the economy concerned.

Aristotle argued that virtue lay in a "mean between two vices", and since the Enlightenment, most democratic nations have sought, consciously or otherwise, to maintain a balance be-

tween collective action and individual liberty; between co-operation in the pursuit of public goods and the creative power of competition; and between respect for social values and the pursuit of individual self-interest. In the field of economics and business, the search for such an elusive balance has been not merely for an optimal trade-off between social fairness and economic efficiency but also for the most efficient model of capitalism itself. It has long been understood that efficient market-based capitalism requires more than a system of market exchange, property rights and the rule of law. Social norms engendering trust and removing the threat of opportunism are essential if economic agents are to engage in any relationships more durable than "spot transactions" without being burdened by the costly (and ultimately futile) search for the "complete" legal contract.

Organisational structures, too, have a profound impact on economic efficiency, depending on the extent to which they enable, for example, co-operative innovation and teamwork. Without these, markets all too easily fail to maximise economic and social value – producing too much pollution because its value is not reflected in market prices, or producing too little employee training or customer-specific investment by suppliers because – in the absence of commitment mechanisms – they are unduly risky. But as Aristotle might have pointed out, too much commitment between economic agents can be as damaging as too little – leading to social and economic rigidity and a lack of incentives. There must be a balance between commitment and flexibility and between public and private goods.

Over the last fifty years, many different models of capitalism have emerged which seek in different ways to achieve such a balance. Their evolution has, of course, been to some extent path-dependent – reflecting pre-existing differences in institutional structures, economic specialisations, and political coalitions. While most OECD countries (and some regions) have distinguishable versions of capitalism, two models (often in somewhat idealised form) have come to typify two essentially divergent approaches. One is the US model, which typifies the liberal market approach seen in Anglo-Saxon countries; the other is the German model, which shares many features with other so-called "co-ordinated" market economies, such as those of Sweden and Japan. There are, of course, some hybrid systems such as the French, but for reasons of brevity, this article will concentrate on a schematic comparison between the archetypal German and US models.

Both models share a broad acceptance of free trade, market determined product pricing and autonomous monetary policy. But, whereas the US model largely relies on market co-

ordination of economic agents and seeks to address market failures by providing additional market elements where they are missing (e.g., tradable pollution permits, patents, etc.), the German model relies in many areas on non-market coordination, supplemented by a generous system of welfare protection. So, for example, Germany has a widespread and successful vocational training system that is underpinned by cooperation: between firms in the setting of standards and the avoidance of free-riding; between firms and employees, through collective wage bargaining and co-determination (via a largely mandatory system of works councils and worker participation on supervisory boards); and between these social partners and the education system.

There is also substantial inter-firm collaboration in research and development (in conjunction with state-sponsored research institutions). Employees and companies alike are willing to make substantial relationship-specific investments and technology transfers on the basis of the trust engendered by co-determination, formal business organisations and the long-term provision of capital from "hausbanks" and committed cross-shareholdings. All this contrasts markedly with the US model with its "residual" welfare state, and its emphasis on competitive relations between companies, flexible labour markets, management autonomy, general education, market-determined technological standards and capital market financing. US companies have, of course, often succeeded in inspiring commitment from staff by creating a cohesive internal corporate "culture", and their focus on shareholder value can demand an impressive attunement with the desires of the marketplace. Extensive legal liability, shareholder activism and, in some cases, "social audits", can also align the interests of the US corporate sector with broader social goals.

Over the last decades, there has been considerable focus on the degree of flexibility shown by the different models in response to economic shocks, technological changes and the internationalisation of capital markets. In Germany, as in many other European countries, a high degree of employment protection appears to have interacted with other labour rigidities and with demand shocks to create an "insider-outsider" problem in the labour market – preventing the wages of those still in work being bid down low enough to price the unemployed back to work. Moreover, extensive cross-shareholdings, long-term bank finance, and co-determination (the very features that have helped underpin a long-term approach to investment and innovation) may have also prevented reallocation of capital and resources to radically new technologies with the scale and rapidity that we have seen in the US.

By contrast, flexibility is built into the heart of the Anglo-Saxon model, in particular by the rigours of the capital markets on which it relies for finance. Given the emphasis on tangible short-term returns (outside the area of hi-tech start-ups), companies need a high degree of flexibility to react quickly to product-market and technological developments. They therefore place a high premium on management autonomy and the ability to hire and fire. The market for corporate control in particular increases the need for flexibility.

What then is likely to be the impact of the spread of international capital market financing and a market for corporate control to Germany? Will it imply a further need for flexibility? And if German companies are forced by capital markets and hostile takeovers to adopt a more short-term focus, will this imply that many of the "commitment" features of the German model become seen as harmful "rigidities"? To many commentators it seems clear that the German and other similar models no longer represent the optimal trade-off between commitment and flexibility. Faced with the internationalisation of finance, a revolution in technology and persistently high unemployment, they seem to need a new mix of institutions – retaining, for example, a vocational training system, but combined with greater labour-market flexibility. Such thinking suggests that it may be time for a new institutional compromise incorporating the best of the various national models, perhaps now at a European or international level since many of the key institutions or actors are no longer nationally bounded.

For various reasons, however, the smooth evolution of a new hybrid model – representing a finely calibrated compromise – may not be likely. To expect such is to ignore the extent to which the various features of any one model are interdependent, limiting the possibility of cherry-picking features from other models without introducing institutional inconsistency. It may be no accident, for example, that countries with liberal capital markets and flexible labour laws have generally been relatively unsuccessful in vocational training, incremental innovation, and long-term investment. Employees who are unsure of their prospects may not choose to invest in very specific (as opposed to general) training, while companies operating in a market for corporate control may be more wary of inter-firm co-operation in technology transfer and more driven to maximise shareholder value over the short term.

To the extent that the German system is, then, a complex system of mutually-reinforcing and interdependent features, the change of some key features, such as the introduction of hostile takeovers and less employment protection, might imply a radical shift to a new institutional equilibrium. It is a general feature of complex systems involving increasing returns from a

complementary mix of factors that the change of certain key elements can lead to a non-linear development and to a sudden "flip" to a new self-reinforcing equilibrium. The timing and extent of such a change is usually difficult to predict.

At the same time, however, the fact that a major reform might lead to a radical unraveling of the whole model concerned should ensure that those key actors who benefit from its existence strive hard to preserve it. This should be especially true to the extent that each model meets the functional requirements of that country's particular specialisation. Countries have generally developed specialisations that suit their respective institutional structures and vice versa. This in turn gives key national actors a strong vested interest in retaining those institutions they deem essential to the competitiveness of their respective specialisations. The institutional framework of the US, with its strong venture capital, general education and flexible labour laws – suits admirably an economy focused on high-technology industries characterised by radical innovation.

But, likewise, the German system, with its vocational training and long-term cooperation, may be ideally suited to engineering industries reliant on incremental innovation, long-term investment and the production of customer-specific products. Wholesale change in either system might entail a weakening of that country's area of comparative advantage. This does not, however, prevent pressure for change if a country's preferred area of specialisation is contested and if key actors (such as international investors) are not nationally bounded and therefore do not share the system's interests.

It is the interdependence of the features of each model of capitalism and the different functional requirements of each country's particular area of specialisation which make prescription in this area so difficult. Not only do national models of capitalism reflect historical political compromises and core social values, they can also represent part of the very basis of each country's comparative advantage. Effacing national differences may deprive the world economy of some of its economic vibrancy and diversity.

There may be good economic as well as democratic reasons for hoping that international actors in the world economy seek to exploit the comparative advantages of different models of capitalism rather than remove them. Some change – perhaps significant change – is necessary or inevitable in most models if they are to achieve a balance between flexibility and commitment that is suited to the demands of the modern global economy. But, as the eighteenth century German philosopher Herder argued, it is important for each nation to sing its own song

and develop according to its own distinctive historical rhythm. Transposing his scepticism of the logic of universalism to today's context might suggest that international capital markets, no less than the European Union, should respect a degree of subsidiarity. Each country needs to find its own path to economic efficiency, regardless of how full a participant it is in the global economy of tomorrow.

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