

**Together we rule, divided we stand: public employers  
as semisovereign state actors and the political economy  
of public sector wage restraint in Germany**

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## ***LIST OF ABBREVIATIONS***

- BAT = *Bundesangestelltentarifvertrag*. Federal Collective Agreement for white-collar workers
- BMT G II = *Bundesmanteltarifvertrag für Arbeiter gemeindlicher Verwaltung und Betriebe*. Federal Collective Agreement for blue-collar workers at the local level
- CISL = *Confederazione Italiana Sindacati Lavoratori*. It is the Italian Confederation of Workers' Trade Unions.
- CME = Coordinated Market economies
- CPE = Comparative Political Economy
- DAG = *Deutsche Angestelltengewerkschaft* The German Union of Salaried Employees
- dbb = *Deutscher Beamtenbund*. German Civil Servants' Association
- DESTATIS = *Statistisches Bundesamt*. German Federal Statistical Office
- DGB = *Deutscher Gewerkschaftsbund*. German Trade Union Federation
- DPG = *Deutsche Postgewerkschaft*. German Postal Union
- ECB = European Central Bank
- EIRR = European Industrial Relations Review
- EMU = European Economic and Monetary Union
- GdED - *Gewerkschaft der Eisenbahner Deutschland*. Union of German Railway Employees
- GdP = *Gewerkschaft der Polizei*. Police Union
- GDP = Gross Domestic Product
- GEW = *Gewerkschaft für Erziehung und Wissenschaft*. Union for Education and Science
- HBV = *Gewerkschaft Handel, Banken und Versicherungen*. Trade, Banking and Insurance Union
- HICP = Harmonized Index of Consumer Prices
- IG Medien = *Industriegewerkschaft Medien*. Media Industry Union
- IG Metall = *Industriegesellschaft Metall*. Industrial Union of Metalworkers
- ISIC = International Standard Industrial Classification of All Economic Activities

ISIC International Standard Industrial Classification

KVA = *Kommunalen Arbeitgeberverbände*. Association of Local Government Employers

LME = Liberal market economies

MED = Macroeconomic Dialogue

MPIfG = Max Planck Institute for the Study of Societies

MTArb = *Manteltarifvertrag für Arbeiter des Bundes*. Federal Collective Agreement for blue-collar workers

NPM = New Public Management

OCA = Optimal currency area

OECD = Organisation for Economic Co-operation and Development

ÖTV = *Gewerkschaft öffentliche Dienste, Transport und Verkehr*. Transport and Communication Union

SGP = Stability and Growth Pact

SPD = *Sozialdemokratische Partei Deutschland*. German Social Democrat Party

TdL = *Tarifgemeinschaft deutscher Länder*. Bargaining Association of the Länder

TdL = *Tarifgemeinschaft deutscher Länder*. It is the employers' association representing the interests of Länder governments in collective bargaining.

TV-L = *Tarifvertrag Länder*. It is the new collective bargaining framework signed in 2006 by the unions and the TdL. It regulates through collective bargaining the employment terms of public employees employed at the Länder level.

TVöD = *Tarifvertrag für den öffentlichen Dienst*. It is the new collective bargaining framework signed in 2005 by the unions and the municipal and federal employers. It regulates through collective bargaining the employment terms of public employees employed at the municipal and federal level.

ULC = Unit Labour Costs

Ver.di = *Vereinte Dienstleistungsgesellschaft*. United Services Union

VoV = Varieties of Capitalism

VKA = *Vereinigung der kommunalen Arbeitgeberverbände*. Association of Local Government Employers.

VKA = *Vereinigung der kommunalen Arbeitgeberverbände*. It is the employers' association representing the interests of municipal employers in collective bargaining.

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Curiosity. A good mood. No envy.

Donato Di Carlo  
Cologne, 27.3.2019

**Together we rule, divided we stand: public employers as semisovereign state actors and the political economy of public sector wage restraint in Germany**

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“All States are employers. Although the role of the state in LMEs is in theory more limited than in CMEs, and although in much of the world the last two decades have seen a process of privatisation of public enterprises and contracting out of public services, almost universally the majority of those working in the military, law enforcement and public administration, and at least a substantial proportion in health, education and social services, are state employees (and those who are not are nevertheless typically subject to indirect state control of their employment conditions). This makes the state, broadly defined, the largest single employer in most countries. As a result, one may add, the simple notion of ‘three actors’ in industrial relations – workers, employers and government – is inadequate, since the state so to speak occupies two seats at the table”.

Hyman (2013, 108-09)

“Compared with the rest of the economy, the public sector is special in that the state is necessarily both a party to employment regulation and the authority that defines the rules of the game ... in the public sector, the principle of collective bargaining most sharply encounters the doctrine of state sovereignty due to the dual role of the state as both sovereign power and employer”.

Traxler (1999, 57)

“The *political* nature of the government as the key factor leading to differences in public and private sector industrial relations is well recognised by researchers, although the precise mechanisms and means by which political forces influence public sector industrial relations structures, processes and outcomes have certainly not been identified and researched in sufficient depth and detail”.

Beaumont (1992, 12)

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## SETTING THE SCENE

### *INTRODUCTION*

There is an elephant in the European corridors. Some might say there is, again, a “German question” in Europe. Since reunification, Germany has been held up for being both too weak first and, more recently, too strong. While it is today not so common to recall the days in which Germany was the “sick man of Europe”, it is indeed quite common to blame “it all” on Germany’s current economic prosperity. Critics of Germany often join forces with critics of the European Economic and Monetary Union (EMU). The elephant, they say, is Germany’s inconsiderate export-led strategy of economic growth, made possible by the irrevocable fixation of trading partners’ exchange rates within the monetary union. This strategy, macroeconomists explain to us, is based on repressing the domestic sector while free riding on the European peers’ aggregated demand for the accumulation of current account surpluses (Flassbeck and Lapavitsas 2013).

By joining a monetary union, countries relinquish the capacity to control exchange rates and monetary policy. Thus, the two remaining policy domains – wage and fiscal policy – have come to constitute the central pillars around which this critique revolves. On the one hand, a trajectory of marked wage restraint throughout the German economy has produced a substantial internal devaluation which conferred on German employers a cost competitiveness premium vis-à-vis its competitors. On the other, due to an “allergy” to public spending and a weak institutional capacity to plan and implement public investments (Roth and Wolff 2018), the government’s restrictive fiscal stance has led to the accumulation of budget surpluses. The combination of wage restraint and budget surpluses contributes to repress total domestic consumption, private and public respectively. An economy with a subdued domestic sector, with both private and public consumption restrained, must eventually run at a relatively lower inflation rate. The combination of lower-than-competitors’ wage growth (measured in terms of unit labour costs’ (ULCs) inflation) and low-price inflation yields a more competitive real exchange rate (REER). In a monetary union where competitors cannot devalue their currencies, a more competitive REER is conducive to the accumulation of trade surpluses, on which the German growth model is now said to thrive (Baccaro and Pontusson 2016).

As far as we can tell, the stellar size of the German current account surplus is unprecedented and undeniable: after having reached its peak of 8.9% of GDP in 2015 it is currently projected at a 6.9% of GDP for the year 2020. The same goes for budget surpluses which have been consecutively reported since 2014 (AMECO Database).

This dissertation, however, has *no* desire to enter such a delicate debate on the merits and normative desirability of the German macroeconomic model in the EMU. Much has been written in this regard by other Comparative Political Economy (CPE) scholars and the debate, far from having been settled, seems just about to kick off. What is of relevance for the purpose of this dissertation is the fact that what lies at the heart of Germany's adjustment process – through which the country has gone from being considered the sick man of Europe to becoming its “economic superstar” (Dustmann et al. 2014) – is a trajectory of marked wage restraint. The driving motive behind the dissertation is that during this long process of internal devaluation, various things which occurred seem to have gone unnoticed by many. The research effort takes off from the following empirical observation. Since the inception of the EMU (and actually throughout the 1990s), a pattern of wage restraint<sup>1</sup> in Germany has indeed occurred in the private sector. But it is in the public sector where the most remarkable trajectory of wage restraint can be detected (Di Carlo 2018a; Müller and Schulten 2015) (see also figures 4 and 5). As the literature review will show, while much has been written on the private/export sector, very little is known about structures, processes and outcomes of public sector wage setting, in Germany and beyond. The subject matter of this dissertation is therefore the study public sector wage setting, in theory and in practice.

In assessing the importance of public sector wages in the EMU, we learn from previous studies that current account imbalances in the single currency were significantly associated with the divergent trajectories of members' public sector wages (Johnston 2016; Johnston, Hancké, and Pant 2014). In fact, public sector wage trajectories among the EMU participants diverged substantially after 1999 (figure 5). Countries which successfully kept public sector wage inflation under control remained relatively more competitive within the monetary union, accumulating trade surpluses; and *vice versa* (Hancké 2013). Public sector wage growth has been proven to affect private sector wage growth (Afonso and Gomes 2008). With regard to the period before the crisis, economists have found a strong positive correlation and co-movement between public and private sector wages which, in a number of EMU countries, coincided with strong public wages' growth and losses of overall competitiveness (Holm-Hadulla et al. 2010). In this sense, the divergent growth trajectory of countries' public sector wages has contributed to exacerbate the process of countries' structural ULCs divergence which a variety of studies considers as the Eurozone crisis' culprit (Flassbeck and Lapavistas 2013; P.A. Hall 2012; Hancké 2013; Höpner and Lutter 2014; Iversen and Soskice 2013; Johnston 2016; Johnston, Hancké, and Pant 2014; Johnston and Regan 2014; Scharpf 2011).

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<sup>1</sup> By wage restraint here I mean nominal wages, discounted by total labour productivity in the economy, which grow slower than the common ECB's inflation target of “below but close to 2%”. This formulation refers to the *golden rule of wage bargaining* which will be discussed in greater detail in due course.

Public sector wage setting becomes all the more interesting for countries of the EMU if we furthermore consider that, since public wages are paid out of governments' budgets, public sector wage policy is a major item of fiscal policy. In other words, public sector wage policy is a subset of the government's overall fiscal stance. Public sector wage policy is thus a unique policy space in the present European macroeconomic regime where the only two policy domains left under the remit of national and democratically elected governments *coincide*. As a result of the notable size of the wage bill in public budgets (figure 2), looking at the convergence/divergence of public sector wage policy among the members of the union is therefore an interesting way to look at countries' coordination of fiscal policy within the EMU. In relation to these considerations, studies have found that public sector wage policies, before the crisis, contributed to intensify pro-cyclical fiscal policies across the EMU members, pushing apart country-specific economic cycles (Holm-Hadulla et al. 2010).

We know, in other words, that public sector wage setting matters in different ways within the macroeconomic regime of the EMU. Yet what we do *not* know is what explains the adoption of these national public sector wage policies in the first place. As a first step in starting to address this wider question, in this dissertation I have selected the German case of public sector wage restraint because it satisfies the conditions of an extreme and crucial case study with substantial real-world implications. The dissertation looks at the German case in between two historical junctures, German reunification in 1990 and the financial crisis in 2008.

Germany is extreme because the entity of the public sector wage restraint which needs to be explained assumes extreme values in the mid-2000s. Within the divergent growth trajectories of members' public sector wages which can be observed since the inception of the EMU (figure 5), it is the only country that pursues such a remarkable pattern of restraint. It is an outlier in this respect. Moreover, Germany is a crucial case for the scholarly literature because it constitutes a most-likely case in which to expect an explanation of public sector wage restraint based on the established pattern bargaining thesis. This argument, I will show, cannot be validated in the very crucial case for which this theory has been popularised in the first place. In fact, what I term "*the pattern bargaining hypothesis*" maintains that public sector wage restraint in Germany is ensured via the country's specific wage bargaining institutions through which public sector's wage growth is pegged to that in the export sector, ensuring overall wage restraint across the economy. It will be shown that this explanation does not withstand the test of empirical observation, leaving us in the dark as far as our understanding of public sector wage restraint in Germany is concerned.

This dissertation thus addresses the following central question: *what explains Germany's trajectory of public sector wage restraint vis-à-vis its EMU peers?* Posing this question has both policy relevance and theoretical importance. With regard to the former, the dissertation speaks to the necessity of finding an answer to the bigger question which has implications for the smooth functioning of the EMU, namely: *why*

*have countries which were subjected to the same hard monetary regime experienced such divergent trajectories of wage growth in their public sectors?* Working out an answer for the German case is crucial because Germany is the most populous member and most powerful (politically and economically) actor at the heart of the single currency. Theoretically, asking this question assumes importance in light of the failure of the pattern bargaining hypothesis in explaining Germany's public sector wage restraint. In fact, the theoretical question the dissertation poses in light of this failure is the following: *if we cannot explain Germany's public sector wage restraint through the theory of inter-sectoral wage coordination via export-led pattern bargaining, what other factors, so far unaccounted for, explain Germany's trajectory of public sector wage restraint?* In answering this theoretical question this dissertation will not only challenge a dominant theory in the field of both CPE and industrial relations studies. It will also provide a more accurate historical and institutional explanation for the case at stake with the hope to produce new information that shall add incrementally to our current stock of knowledge on public sector wage setting and industrial relations more generally.

To answer these questions, the dissertation will employ a two-step process tracing methodology. I blend together elements of deductive and inductive process tracing. As a first step in the explanatory effort, I proceed with theory testing process tracing to test the validity of extant explanations for the case at stake. Subsequently, after having refuted alternative explanations, I proceed with a more inductive type of theory-guided process tracing for the purpose of explaining the German case of public sector wage restraint.

#### *THE ARGUMENT OF THE DISSERTATION*

In line with actor-centred institutionalism (Scharpf 1997b), on which this dissertation draws, I distinguish between phenomena's *proximate* and *remote* causes. Proximate causes behind the adoption of given policies are to be found in the actors' interacting choices while institutional conditions are treated as remote causes in that they provide the institutional structures within which these policy choices are made (Scharpf 2000, 764).

The proximate cause behind Germany's trajectory of public sector wage restraint vis-à-vis its EMU peers, I posit, is the public employers' necessity to achieve fiscal consolidation through wage restraint given the lack of fiscal autonomy on their fiscal revenues' side. Through public sector wage setting, the German public employers went on the offensive against the unions in order to rein in the fiscal costs of wage setting in the public administration. To save money, they also attacked all other aspects of the employment relation as well. They managed to extend working hours, to merge and reduce bonuses, curtail holiday and overtime payments so that wage restraint was but one dimension of this strategy of consolidation. The public employers' necessity for

fiscal consolidation, however, is not homogeneously distributed among the three German public employers (i.e. the Federal, the States and municipal levels). This is because it is mediated by the institutional configuration of the German state. Three institutional domains structure wage setting interactions in the public sector and shall therefore be considered remote causes behind Germany's pattern of restraint. These are: the fiscal constitution of the German state, which regulates the public employers' capacity to raise revenues; the structure of the politico-administrative system which defines the organisation of the polity and the distribution of legal competences and public personnel within it; the system of public sector employment relations and interest representation which regulates the process of wage determination in the public administration.

On the revenues' side, Germany's fiscal federalism system is unique. Its central feature is the centralisation of tax legislation at the federal level in addition to the Länder's legal capacity to veto tax legislation in the Bundesrat. This means that, neither the Federation nor each Land alone can independently manipulate their tax revenues at will. The structure of fiscal revenues is thus rigidly fixed according to pre-decided formulae which, to be changed, require a negotiated change of the constitution capable of winning hard-to-achieve qualified majorities. On the expenditures' side, the asymmetric distribution of competences decreed by the German constitution yields an asymmetry in the stock of labour costs which the different German employers face. While the Federation has mostly legislative competencies, most of the administrative competencies lie within the remits of the Länder and the municipalities. As a result, within the German politico-administrative system, the bulk of public employees are employed by Länder and municipal employers. The interaction effect between a legally constrained fiscal autonomy and an asymmetric distribution of personnel costs has created scope for fatal conflicts of interests among the public employers. Public sector wage setting in Germany is regulated by a hybrid system of public sector employment relations. Public employees are regulated through collective bargaining. Here wage restraint could be pursued thanks to public employers' strength in the face of unions' structural weaknesses. A weak mobilisation capacity among Länder's public employees and dynamics of privatisations and outsourcing of municipal services have undermined the capacity of public sector's unions to hold out against the employers' offensive. Civil servants are instead subjected to the state's sovereign authority. Here wage restraint could in theory have been pursued via unilateral legislation. Yet, in practice, this could rarely be the case because public employers were internally divided. Thus, I argue, the state's sovereign authority in public sector wage setting is *de facto* not absolute but contingent: it can only be deployed under the condition that public employers overcome their internal dividedness.

In rebuttal of the "*pattern bargaining hypothesis*" which sees public sector wage restraint as a by-product of export sector's dominance in inter-sectorally coordinated wage bargaining across the economy, this dissertation argues that the public employers

are crucial state actors who are *no subaltern* to a producer groups' coalition in the German export sector. In other words, I suggest that the state should not be thought of as a mere executor of the economic affairs of "dominant" producer groups in the export sector. Implicit to these arguments there lies an understanding of the German state as a monolithic bloc capable of frictionless unitary action, which export sector's actors can capture. However, there is no such thing as a German government. Germany is a "semisovereign state" characterised by a fragmented polity in which political authority in important policy areas, most notably public sector wage policy, is assigned to or shared with the sub-national governments which compose the Federation. Thus, to paraphrase Katzenstein (1987, 16), the "federal government has no choice but to negotiate and cooperate with centres of state power over which it has no control". Hence, if there is no single centre of political power in the German political economy, there must be no single political entity over which export sector wage setters can so smoothly exert their dominance. This complicates matters.

The dissertation argues that the state is not a neutral actor in public sector industrial relations. Nor is it a mere instrument of a dominant social bloc in the export sector, as implicitly assumed in these arguments. The state matters and is crucial for the study of public sector wage setting. But who and what is the state? I posit that the state should be understood as an institutional contextualisation. The state does not act in public sector wage setting. Public employers do; within the legal and institutional contours of the state. Modern States are fragmented and decentralised. They are ensembles of multiple institutional entities and centres of political power each with its own interests, preferences and strategies. Nothing ensures us that these interests will be aligned among themselves, nor that they will be aligned with those of an export sector's elite. Rather, States' fragmented nature creates scope for intra-state conflicts of interests in policy making. Public sector wage setting in Germany is a case in point. What characterises the German public employers is, in fact, their *internal dividedness*. So the state matters. But it is not a unitary actor. Through a detailed historical reconstruction, it will be shown that the public employers follow their own logics which are fully independent from the export sector producer groups' necessity to ensure the competitiveness of German goods in international markets. Quite to the contrary, the dissertation shows that in different occasions, militant unions in the German export sector managed to break up with the pattern of moderation started in the public sector and push their pay settlements up. For the public employers these expensive patterns created headaches. While the public employers were desperately trying to save money through public sector wage restraint, at times the export sector's patterns forced them to revise upwards their initial meagre pay offers. In other words, the public sector unions could point at the generous export sector settlements and *play the pattern* against the stingy public employers. Thus, I posit that public employers' interests are rooted in the organisational imperatives of the state institutions they represent. At their core, these

interests are *fiscal* in nature, i.e. the public employers must guarantee the financial soundness of the public organisations they are responsible for.

The story of public sector wage setting in post-reunification Germany is a story of a *political misalignment* within the public employers' wage bargaining coalition. For more than forty years, a wage bargaining coalition (*Tarifgemeinschaft*) stipulated by the three public employers of the German administrative system (the Federation, the Länder and the municipalities) had ensured unity in collective bargaining negotiations. As a result, public sector wage setting in Germany (differently from the private sector's) had for long been centralised and encompassing under the formal leadership of the federal Minister of the Interior. This guaranteed uniformity of employment conditions and pay terms across the country. Similarly, civil servants' pay determination, which in Germany is part of a separate legal sphere, had for long remained a legal competence in the remit of the federal government. Thus, the fact that until 2006 the federal level set the terms of employment and pay has ensured uniformity across the country's civil service at all levels of government. The two distinct legal spheres were kept coordinated via a system of *intra-public-sector pattern bargaining*. The pay settlements negotiated through collective bargaining were then transferred to the civil servants via legislation drafted by the Ministry of the Interior and approved by the federal parliament.

Reunification dealt a blow to the finances of the German public employers. This coincided also with a prolonged period of slow economic growth and high unemployment not least because of the Bundesbank's decision, in the early 1990s, to severely tighten monetary policy. After the inflationary pressures which followed reunification, through a stop-go type of monetary policy, the Bundesbank intended to "punish" policy actors for the loss of fiscal and wage discipline. The central bank did not digest the government's expansionary fiscal policy, the wage setters' exuberance *and* the government's weak stance in public sector wage setting. The economic recession which ensued meant lower tax revenues, higher social expenditures and an increasingly tighter fiscal space available to public employers. The tighter the fiscal space grew, the more constrained the public employers' ability to pay became. In winter 1996, when Germany risked missing the 3% deficit rule agreed in Maastricht, the public employers united behind the leadership of the federal Finance Minister Theo Waigel. In order to achieve fiscal consolidation the public employers pushed aggressively for a two-year "zero wage round" in the public sector. The unions caved in but, in the process, managed to obtain a modest pay settlement instead of a wage freeze and cuts in sickness pay. Public sector wage restraint was instrumental and perhaps fundamental for Germany to comply with the Maastricht criteria by 1997. This is because the Social Democratic Party (SPD) in opposition and the Länder governments were blocking other cost-cutting measures through the *Bundesrat*. In all, the three governmental levels remained united within the public employers' coalition throughout

the 1990s and, in pushing through a fierce pattern of restraint in 1996, supported the firm stance of Theo Waigel.

With the collapse in tax revenues caused by the Schröder's tax reform (especially the 2001 step), the public employers' fiscal space grew tighter and tighter in the 2000s. Germany was being held up as the sick man of Europe. At the same time it remained under the radar of the European Commission for its consecutive breaches of the 3% deficit rule. Within this context of financial hardship, a political conflict emerged among the public employers which eventually led to the partial decentralisation of public sector collective bargaining. With their finance in dire straits, in 2003 the Länder governments decided to pull out of the historical public employers' coalition. This decision was primarily rooted in the disproportional stock of personnel costs the Länder public employers face. This is due to the asymmetric distribution of administrative competencies which the German constitution assigns to sub-national governments. This asymmetric distribution of labour costs is made irremediably problematic by the centralisation of tax legislation which characterises the German fiscal federalism system. As a result of the lack of fiscal autonomy, the Länder could not adjust their revenues in the face of structurally rising costs of public sector wage setting.

By threatening to leave their Länder employers' association (*TdL*), the States forced it to quit the wage bargaining coalition with the Federation and municipalities. In so doing, they pushed instead for the institutionalisation of a new system of Länder-level collective bargaining (the TV-L contract agreed in 2006). This was meant to contain the fiscal costs of their personnel expenditures by escaping the leadership of the federal level in wage negotiations. Also, it consisted of a strategic move to "get rid" of the municipal employers. The municipal level had always been the weak chain of the bargaining coalition due to the employers' fragility vis-à-vis workers' militancy in key infrastructural services (e.g. local transport, waste disposal, etc.). In parallel to the overhaul of the hitherto centralised collective bargaining framework, the Länder also succeeded in obtaining the return of the legislative competence on their civil servants' careers and pay. This occurred within the context of the reform of the German fiscal federalism in 2006.

The federal and municipal employers decided instead to stick together and negotiated a new joint collective bargaining framework (the TVöD contract agreed in 2005) with the trade unions. The condition for the municipalities to remain together with the Federation was that the design of the TVöD be premised on the need of municipal employers (represented by VKA) to reduce the costs of public services' provision in the face of ever tighter budgets. The unions went along with the municipal employers' desires under the serious threat of privatisations and outsourcing of municipal services. In fact, during the 2000s, the trade unions were pushed on the defensive in all these processes and had to compromise with concessionary bargains. They preferred to compromise rather than see the whole collective bargaining edifice disintegrate. The

two-tier collective bargaining system to which they agreed, although a second best for them, is still to be preferred to the full collapse of collective bargaining.

Wage restraint was pursued throughout this period in the form of extended working hours, benefits' cuts and meagre lump sums. These were conceded to the unions (during the period 2005-2008) in exchange for their agreement to the reforms. To maintain the collective bargaining framework alive, the unions needed – and still need – the public employers to remain united as a negotiating partner. Paradoxically, since the unions need united public employers more than the employers actually wish to be together (due to their internal conflicts of interest), the political divisions among the public employers ended up strengthening their bargaining power: were the unions not to accept public employers' demands for fiscal savings, employers would pull out of their associations and collective bargaining would collapse, making bargaining unmanageable for the unions.

Eventually, the result of this parallel process of institutional and constitutional changes has led to the institutionalisation of what I term a “low-wage institutional equilibrium” in public sector wage setting. This is a situation in which public sector wage policies in Germany can only be set as a *lowest common denominator* which negotiators must find by calibrating public sector wage policies according to the poorer employers' ability to pay. Thus, this institutional setting creates a structural bias toward wage restraint in public sector collective bargaining. By equilibrium I mean, specifically, a situation in which no actor has an interest in challenging the *status quo*. Each of the three public employers benefit from the current institutional configuration, although in different ways. This is clearly an employers' friendly *status quo* which the unions can only challenge at the risk of ending up in an even worse situation, i.e. the complete collapse of collective bargaining in the public sector. For the unions, the current institutional configuration represents a second best which is worse than the *status quo ante* when the system was centralised and encompassing. But the current system is anyway better than atomistic and fragmented bargaining. This equilibrium, I argue, currently prevents the pursuit of policies of public sector wage/fiscal inflation which may be desirable to reflate the German economy and provide a more symmetric adjustment within the EMU. The equilibrium consists of three complementary legal dimensions of which Germany's public sector wage setting is now composed: the TVöD contract which regulates public employees at the federal and municipal level; the TV-L contract which regulates public employees at the Länder level; the legal competence on civil servants' pay which is now within the remits of each of the Länder's legislators.

Within the TVöD, the only wage policies which can obtain a majority in the VKA's *Mitgliederversammlung* (members' general assembly of municipal employers), are those which are calibrated according to the poorer municipalities' ability to pay. Even assuming an inflationary policy would somehow make it through a majority, were this policy to be too expensive, poorer municipalities would sooner or later leave the VKA.

This is possible because membership is voluntary. This means wage policies need to be set as a lowest common denominator between the poorer and richer municipalities and the federal level. Since the federal level knows that wage policies beyond the poorer municipalities' ability to pay will produce a stalemate of the whole wage bargaining machinery, during normal times, it converges by default on the VKA's internal need to accommodate various stakeholders. This creates a structural downward tendency which prevents the pursuit of policies of public sector wage inflation in the TVöD.

In the TV-L contract poorer and richer Länder negotiate together within the TdL. Both types of Länder have an interest in a lowest common denominator wage policy calibrated on the poorer Länder's ability to pay. Through horizontally coordinated bargaining the rich States obtain fiscal savings which they can divert to other uses. This is because a lowest common denominator brings about wage policies which are cheaper than the settlements they would have to pay were they to negotiate freely in a fully competitive labour market. Richer Länder have, so to speak, an "interest in being outvoted" by poorer ones within the TdL. The poor Länder instead avoid a system of competitive federalism in which they would lose out against the richer Länder's greater ability to pay. The attainment of the legal competence on civil servants' careers and pay by the Länder squares the circle. It gives richer Länder the possibility to deviate *in melius* from this low-wage equilibrium. In Germany the private sector is generally a more attractive employer and public employees are a scarce resource. Richer Länder's employers who need to compete with the private sector in their local tighter labour markets need a flexibility valve. They need to have the possibility to deviate from these contracts upward in order to remain attractive employers. Since the decision on the legal status of the newly-hired falls on the employers, richer public employers with a greater ability to pay, who need to be more attractive recruiters, can offer better terms of employment through the "civil service valve". This has led to a fragmentation of civil servants' career structures across the country. Pay differentials in the civil service now stand at around 11% between Berlin (the poor) and the Bavaria (the rich).

#### *PLAN OF THE DISSERTATION*

The dissertation is structured around two parts. Each of them has four chapters. Part one is more theoretical in nature. Part two is empirical and deals with the case study.

Part one deals with issues of conceptualisations, theory and methodology. In chapter one I conceptualise the outcome of public sector wage setting deriving it from macroeconomic theory. I then discuss the importance of public sector wage policies within the macroeconomic regime of the EMU and explain the puzzle of Germany's public sector wage restraint. In chapter two I deal with the methodological approach of the dissertation. I explain the logic of case selection, the type of process tracing employed and the sources utilised. In chapter three I perform a wide literature review in

line with suggestions from the best practices of process tracing (Bennett and Checkel 2015; Trampusch and Palier 2016). I “cast the net widely” in search for explanations and other useful insights, relevant for the case of interest. Before concluding the chapter I test empirically the main rival explanation. This leads me to refute it and move forward in the search for an alternative explanation. In chapter four I thus introduce the alternative theoretical approach of the dissertation and discuss theoretical aspects which characterise the key actors involved in public sector wage setting: the public employers and the public sector’s unions. Subsequently, I introduce an analytical framework which theorises the state as the institutional contextualisation within which public sector wage policies are enacted. Lastly, I discuss why to fully understand public sector wage setting we should trace it back to the politics of fiscal policy.

Part two puts the framework into action and proceeds with the empirical analysis of the German case. In chapter five I describe the peculiarities of the German institutional setting. The subsequent two chapters engage with the historical reconstruction of public sector wage setting in Germany. Chapter six covers the 1990s. Chapter seven covers the 2000s. Each of these chapters concludes with an analytical section in which I reflect critically on what could be observed during the historical reconstruction in light of what could be expected on the basis of the literature review. Chapter eight then discusses in greater details the micro-foundations and the institutional logics of the new institutional equilibrium which has emerged after 2006.

In the conclusions I do three things. First, I wrap up the findings of the case study. Secondly, I elaborate on the theoretical aspects of the causal mechanism which this dissertation has uncovered and discuss the scope conditions of what I have termed: “the fiscal mechanism of public sector wage restraint”. By briefly contrasting these findings with the Italian case of public sector wage inflation, I discuss why the mechanism I have uncovered maintains its explanatory power only within the scope conditions of cases of public sector wage restraint. Thirdly, I conclude the dissertation by discussing the wider implications of the dissertation’s findings for the recent turn toward growth models research in CPE. Furthermore, I briefly hint at the implications of the identified institutional equilibrium for Germany’s capacity to offer a more symmetric adjustment in the EMU through wage/fiscal reflation. Alas, my tentative answer is negative.

**PART I. PUBLIC EMPLOYERS AS SEMISOVEREIGN STATE  
ACTORS. TOWARD A STATE-CENTRED INSTITUTIONALIST  
FRAMEWORK FOR THE STUDY OF PUBLIC SECTOR WAGE  
SETTING**

## CHAPTER 1. WAGE POLICIES IN EMU'S PUBLIC SECTORS

This chapter is theoretical in nature. The purpose is to introduce and conceptualise the outcome to be studied. Starting from the golden rule of wage bargaining, in sub-section 1.1, a taxonomy composed of three alternative wage policy options is derived. The typologies of policy options serve as the analytical tool for the analysis to be executed in the dissertation. This exercise is in fact preparatory to conceive of the outcome to be explained, i.e. public sector wage restraint. Sub-section 1.2 then discusses the importance of public sector wage policies for the macroeconomic regime of the EMU. In light of these theoretical considerations, sub-section 1.3 presents the puzzle of Germany's public sector wage restraint within the EMU, clarifying why solving this puzzle has both policy implications and theoretical relevance. Lastly, in sub-section 1.4 I provide a definition of the public sector, i.e. the economic arena in which public sector wage restraint will be analysed.

### *1.1 DEFINING WAGE POLICY OPTIONS IN THE CONTEXT OF THE EMU MACROECONOMIC REGIME*

The aim of the dissertation is to explain a specific type of policy outcome, namely public sector wage restraint. Doing so implies explaining choices in the conduct of public sector wage policy. To accomplish the task, a *typology of policy alternatives* is needed to define the set of possible courses of action (policy options) (Gourevitch 1986) from which any wage setters may choose. This means to conceptualise and define the qualitative outcome to be explained.

There exist two ways of conceptualizing a typology of policy alternatives: via deduction or via induction (Van Evera 1997). In the EMU context, given the available literature, this can be done deductively by resorting to the concept of the golden rule of wage bargaining. The golden rule is an analytical construct derived from macroeconomic theory which acquired great importance at the launch of the EMU. The golden rule was meant to provide a "soft" functional equivalence for the lack of pan-European wage coordination and ensure macroeconomic governability of the EMU. By resorting to this concept, it is thus possible to deduce the taxonomy of policy options. According to the golden rule, nominal wages ought to be set in line with the sum of the common inflation target in the monetary union (the ECB's "below but close to 2%, i.e. 1.9%) and the rate of national average labour productivity.

Golden rule:

$$(1) \quad \Delta\% \text{ nominal wage} = 1,9\% + \Delta \text{ avg. Labour Productivity}$$

Starting from (1), two alternative wage policies which diverge from the golden rule can be defined. When the rate of increase in nominal wages ( $\Delta\%$ ) overshoots the golden rule (upward divergence from the benchmark) we shall treat these as policies of *wage inflation*. When  $\Delta\%$  undershoots the golden rule (downward divergence), we shall consider these as policies of *wage restraint*. As a result, from (1) we can derive the formulation of the two policies.

Policy of wage inflation:

$$(2) \quad \Delta\% \text{ nominal wages} - \Delta\% \text{ avg. labour productivity} > \text{ECB's inflation target}$$

Policy of wage restraint:

$$(3) \quad \Delta\% \text{ nominal wages} - \Delta\% \text{ avg. labour productivity} < \text{ECB's inflation target}$$

In theory<sup>2</sup>, public sector wage setters can thus choose to adopt three alternative types of wage policies in the public sector:

- i. *Policy of the Golden Rule*
- ii. *Policy of wage inflation*
- iii. *Policy of wage restraint*

The policy outcomes are conceived here as *qualitative* ones with characteristics which make them exclusive categories: wage inflation and wage restraint consist of bi-directional types of divergence from the theory-deducted benchmark. Two clarifications are of order. First, since I am interested in understanding structural divergence of wage setting outcomes in the public sector, the qualitative outcome I aspire to explain consists of *trajectories* rather than individual yearly bargains *per se*. This leads me to categorise a country's trajectory as inflationary or deflationary depending on whether public sector wage developments diverge from the benchmark in a systematic way. Secondly, since wage setting in the real world is not such a neat exercise as it is described in theory, to make the taxonomy useful (and meaningful) in practice, it is necessary to grant an "error margin" to the conceptualisation of the wage policy. In this way, countries with public sector wage trajectories *more or less* in line

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<sup>2</sup> Given the difficulty of calculating productivity in most public services and given the absence of a market to determine prices, every such attempt to devise an analytical construct of this kind will remain open to criticism. Nevertheless, so far, the so-called *Golden Rule* remains the best available option, as a composite of the inflation rate (wage floor protecting real purchasing power) and average labour productivity (determining a "fair" wage ceiling based on the average productivity of all workers in the economy). Its importance also stems from the real-world importance which policy makers attached to it at the beginning of the EMU.

with the benchmark can be considered as pursuing policies of the golden rule even when they do not neatly coincide with the mathematical calculation of the golden rule. This, however, is not a problem for the German case of interest here which is, unequivocally, a case of public sector wage restraint.

This way of proceeding necessarily creates room for subjective choices to be made. As such, they shall be open to debate. At the same time however they shall be excused on the grounds of making abstract concepts applicable to the real world for analytic purposes. These wage trajectories are, in other words, conceptualised as ideal types necessary to guide us in the empirical inquiry. Most importantly, it should be clear from the beginning that I do *not* assume that wage setters do necessarily understand, accept and follow the golden rule when setting public sector wages in the real world. Yet the concept of the golden remains analytically important for two reasons. First, for *positive* analysis, it is the analytical benchmark that makes the operationalisation of the dependent variable meaningful in the context of the macroeconomics of the EMU. Second, and consequently, from the perspective of *normative* analysis, setting this benchmark allows us to establish and understand cases which, from the perspective of economic governance in a monetary union, deviate from policy outcomes which would be desirable under the conditions of the EMU. Germany is precisely one of these cases.

Of the three outcomes conceptualised, the dissertation will embark on explaining only one type of public sector wage policy, namely public sector wage restraint in post-reunification Germany. This is because, given the centrality of the German case for both academic theory and policy making in the EMU, Germany requires an inquiry on its own. The following sub-section elaborates on the importance of public sector wage policy within the macroeconomic regime of the EMU.

## *1.2 THE IMPORTANCE OF WAGE POLICY IN THE EMU*

Capitalist economies are inherently unstable and the recurrence of economic shocks is a fact of economic life (Minsky 2008 (1986); Wray 2016). As it has long been recognised, governments' intervention aimed at correcting unstable markets is a necessary function in modern economic systems (Keynes 1936; Musgrave 1959). However, by joining the EMU, the control of crucial instruments of macroeconomic management is removed from the hands of democratically accountable governments (Scharpf 2011). This complicates matters.

Adjusting to the fluctuations of capitalist cycles requires either a "mechanical adjustment" or a "policy-induced adjustment" (Enderlein 2006). The former means that changes in economic fundamentals will trigger a self-enforcing adjustment which, over time, will reinstate equilibrium in the economic system. The latter means that policy authorities intervene to correct the functioning of the market economy to induce the correction of disequilibria. This entails policy makers' use of stabilisation policies.

In theory, there exist four standard policy instruments for macroeconomic stabilisation (Hancké 2013, Ch.5; Scharpf 1991). *Fiscal policy*, which can be of restrictive and expansionary nature, depends on whether the government subtracts from or adds to the economy fiscal resources, defined as the difference between total revenues and total expenditures. *Monetary policy* can also be restrictive or expansionary. In today's monetary policy frameworks it entails the setting of interest rates by the monetary authority so as to steer the economy toward its statutory-mandated inflation target (Carlin and Soskice 2014; Ch. 13). *Exchange rate policy* consists of devaluations or revaluations<sup>3</sup> of a country's nominal exchange rate. This is tantamount to adjusting the price of a country's currency to one's convenience. *Wage policy*, which is also expansionary or restrictive in nature, depends on whether the determination of wages between employers and employees leads to real wages that grow faster/slower than productivity rates.

Joining a monetary union does bring with it costs and benefits. The benefits are mostly concentrated at the *microeconomic level*. It is generally accepted that monetary integration stimulates higher trade and investment by increasing economies' allocative efficiency though enhanced economies of scale and lower transaction costs; that cross-national competition in goods and labour markets brings efficiency gains; that monetary union increases the liquidity of financial markets (Carlin and Soskice 2014, 430). A monetary union reduces the exchange rates' volatility characteristic of systems of flexible exchange rates. In so doing, it also eliminates the political conflicts which ensue from exchange rates' adjustments (Höpner and Spielau 2015) and precludes the emergence of poisonous competitive devaluations across nations. Through the delegation of monetary policy to an independent supranational bank, the EMU also helps countries to stabilise their inflation rates and to bring down interest rates on governments' borrowing. This was particularly beneficial for some of the European economies which had for long time struggled to keep inflation and borrowing costs under control.

Yet joining a monetary union entails severe costs. These are related to the loss of sovereignty over the policy instruments which are generally used for the stabilisation of the economy. Economists have maintained that these costs are greater the less the monetary union resembles an "optimal currency area" (OCA) (Kenen 1969; McKinnon 1963; Mundell 1961). If the economic cycles of participating countries were fully synchronised – as they should in an ideal OCA – then supranational monetary policy would help restore equilibrium in the face of a commonly experienced shock. In the case of a country-specific shock instead, countries with no monetary independence will dispose of no possibility to adjust neither through monetary nor exchange rate policies. If wages were flexible enough and/or if the labour force were sufficiently mobile to

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<sup>3</sup> This depends on the monetary regime. In a flexible exchange rates system: depreciations and appreciations.

relocate elsewhere, then mechanical adjustment would automatically bring the economy back to equilibrium even without policy intervention. Alternatively, if a supranational fiscal budget were present, the asymmetric shock could be counteracted by a transfer of fiscal resources from the unaffected economies to those experiencing the shock.

The OCA theory has attracted criticism and praise whose review goes beyond present purposes. Important is the fact that, in the EMU, a sizeable supranational fiscal budget has not been set up. The EU budget currently stands at around 1% of European GDP. Persistent and heterogeneous labour market and wage setting institutions continue to be a prominent feature of the European political economies: employment protection remains relatively high and collective bargaining widespread (Du Caju et al. 2008; Höpner and Schäfer 2012; Visser 2013). Labour mobility is rather low (Bayoumi and Eichengreen 1997). These structural characteristics make it hard for the EMU to meet the conditions of an OCA.

The failure of the EMU to meet the criteria of the OCA indicates the desirability of “policy-induced” macroeconomic stabilisation. Yet, in the Eurozone, policy makers’ menu is irremediably constrained. The prerogative to set monetary policy is bestowed on a supranational institution, the ECB, modelled on a Germany-inspired type of central banking. This design was premised on an independent and conservative central bank whose primary objective, as laid out in art. 105 of the Treaty on the European Union, is the maintenance of price stability (De Grauwe 2016; Ch.8). Similarly, the possibility to make use of nominal exchange rates’ adjustments is precluded by the very relinquishment of participants’ national currencies. With regard to domestic fiscal policy, members’ full ownership of the policy instrument is *de jure* constrained by the Stability and Growth Pact adopted under the push of the German Finance Minister Theo Waigel (Heipertz and Verdun 2004). This legal provision requires countries’ debt stock to converge toward 60% of GDP and budget deficits to remain below 3% of GDP. A preventive arm is intended to strengthen budgetary surveillance *ex ante*. A corrective arm aims at ensuring Member states adopt *ex post* appropriate policies to correct excessive deficits by implementing country-specific excessive deficit procedures or incur fines.

The EMU thus represents not only a problematic divorce between (supranational) monetary and (national) fiscal authorities (C. Goodhart 1998; Schelkle 2012). It is also a unique macroeconomic regime in which the possibility for policy coordination between European monetary authorities and national wage setters is hampered by the very setup of the macroeconomic regime. The presence of one supranational central bank targeting an EMU-wide inflation level in the face of multiple national wage bargaining systems makes the coordination between wage and monetary policy sclerotic (P.A. Hall 1994; Hancké 2013; Soskice and Iversen 1998).

Before the EMU was created, it was recognised that with a single nominal interest rate set by the ECB, as soon as members' inflation rates and output gaps started to diverge from Euro area averages, monetary policy would have adverse effects, resulting in self-enforcing economic cycles<sup>4</sup>. These destabilizing dynamics would take place via the so-called real interest rate channel: countries with higher-than-average inflation will have lower real interest rates and *vice versa*. For these countries, monetary policy would elicit higher rates of investment and consumption, pushing domestic growth beyond potential, eventually triggering a self-reinforcing inflationary cycle. This would lead to structural overshooting, possible asset prices bubbles and current account deficits (Enderlein 2006). Mechanical adjustment, it was thought, would occur via the so-called real exchange rate channel and prevent destabilisation: high inflation countries would eventually lose competitiveness, which will reduce export demand and stabilise trade balances. In other words, self-reinforcing cyclical phenomena would be counteracted by a decline (or boom) in exports caused by the real appreciation (depreciation) of the exchange rate. The REER channel was thought to prevail over the real interest rate channel so as to prevent full destabilisation without policy intervention (Frankel and Rose 1998).

With the benefit of hindsight, it can be seen today that the REER channel has failed to produce adjustment. On the contrary, due to the presence of heterogeneous wage bargaining institutions, the REER channel has been itself a source of destabilisation. The persistent divergence in ULCs' growth among EMU participants (figure 1 panel b) has resulted in diverging inflation rates (figure 1 panel a), leading to losses (gains) of competitiveness and the accumulation of current account deficits (surpluses) (Hancké 2013; Höpner and Lutter 2014; Johnston 2016; Scharpf 2011).

It is in this unique macroeconomic regime that fiscal and wage policies acquire centre stage as the key instruments available to domestic policy makers and social partners for the governance of the economy. In the absence of supranational stabilisation mechanisms, there remain two fundamental problems for national policy makers in the quest for macroeconomic stabilisation. The first is to prevent *ex ante* that macroeconomic developments at the national level diverge substantially from those in the Euro area, fostering endogenously driven shocks (e.g. divergence in countries' competitiveness positions driven by ULCs' unsynchronised<sup>5</sup> growth). The second

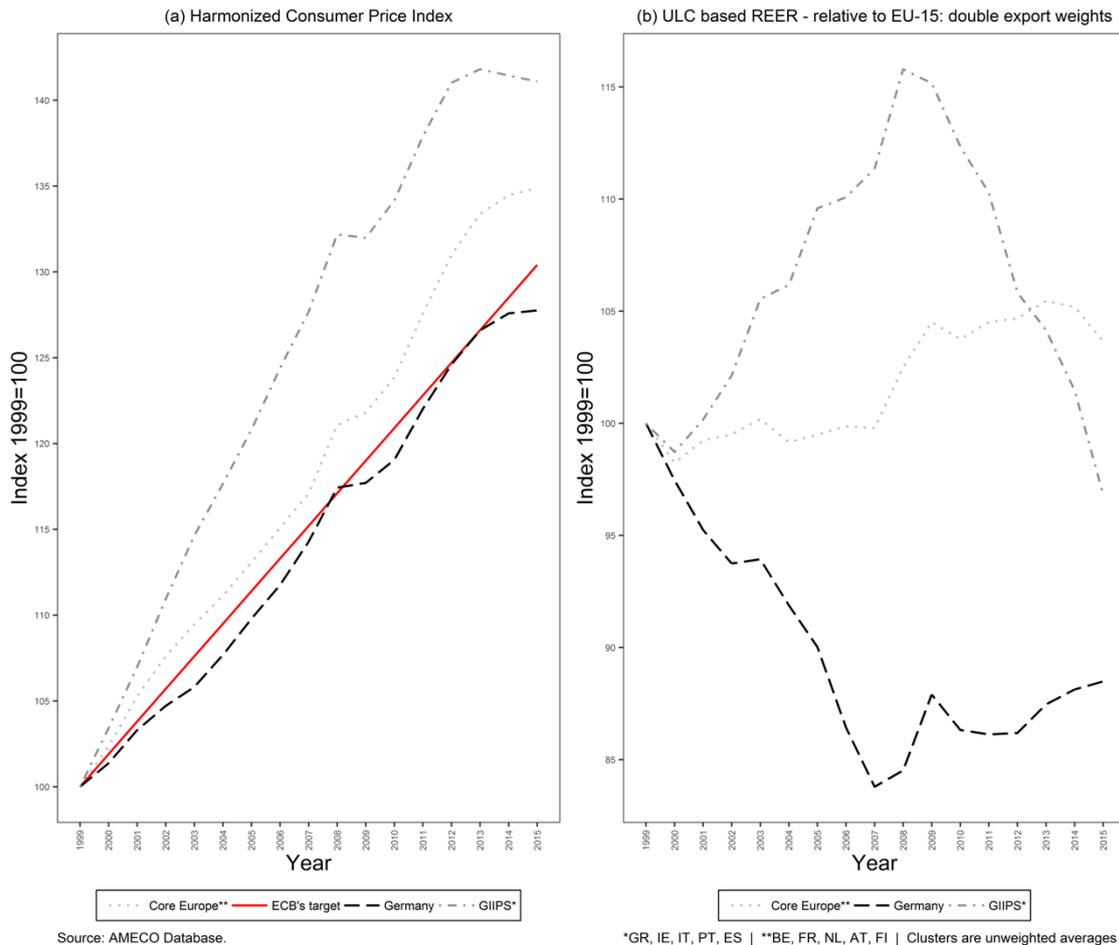
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<sup>4</sup> This policy problem is known as the Walters critique (Walters 1990) named after the British economist who, as an advisor of Margaret Thatcher, argued against UK participation in the EMU. According to this critique, the ECB's monetary policy, by targeting the Euro area as an aggregated average, becomes procyclical as soon as domestic inflation rates and output gaps start to diverge.

<sup>5</sup> I understand *synchronisation* and *coordination* of wage setting, analytically, as two different concepts. The former is desirable in an hypothetical situation in which countries start a monetary union from equal conditions. Synchronisation makes sure that wage developments unfold equally so as to prevent divergence. Coordination does not mean synchronisation insofar as coordination aims at producing different wage setting in different political economies so as to bring the countries in line with each other, *i.e.* synchronised again. From a general perspective it could be said synchronisation be required in

relates to the necessity to stabilise the economy *ex post* after an exogenous shock has occurred (e.g. the financial *cum* sovereign debt crisis). Given the failure of “mechanical adjustment” in EMU, a policy-induced adjustment is indeed desirable.

Figure 1: Inflation levels and real exchange rates (REER) across the EMU. Country clusters (1999-2015)



When shocks hit a fully sovereign country, policy makers have the possibility to design a policy mix for adjustment through the combination of the four mentioned policy instruments. After joining the EMU, however, asymmetric and symmetric shocks will have different impacts on the participants. In the case of symmetric shocks, the supranational monetary authority will act to stabilise the monetary union. This occurs by setting the appropriate real interest rate that – via the effect on consuming and saving behaviour of households – brings the EMU as a whole entity back to its treaty-based inflation target (the so called Taylor principle) (Carlin and Soskice 2014, Ch. 9 - 12). If exogenous shocks are asymmetric among participants, however, the burden of

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tranquil times to prevent divergence, while coordination be required to correct it.

adjustment will fall disproportionately on two domestic instruments: fiscal and wage policies.

During normal times the challenge to a smooth functioning of a capitalist economy is that of preventing national macroeconomic developments from resulting in endogenously driven dynamics that lead to economic shocks. Avoiding national asymmetric developments, which may endanger the union as a whole, has called for pan-European policy coordination. While coordinating fiscal policy across the union was precisely the objective behind the creation of the Stability and Growth Pact (SGP), wage policy was left in the remit of national social partners. Due to weak political will, only “soft” forms of policy coordination were provided in order to avoid divergence in wage policies and asymmetric competitiveness trajectories in the EMU.

Given the lack of a pan-European wage coordination system and the disconnect between national wage setters and the supranational monetary authority, the German EU presidency set up the Macroeconomic Dialogue (MED) at the Cologne European Council in 1999, as a biannual meeting of the ECB, the Council, the Commission and the European social partners. This was an attempt to “improve the conditions for a cooperative macroeconomic policy mix geared to growth and employment while maintaining price stability” (Koll 2005, 175-212). The economic idea underpinning soft coordination was popularised as the *golden rule of wage bargaining*. The rule was put forward by two German civil servants<sup>6</sup> and was adopted by the MED as a formal policy guideline for social partners (Collignon 2009, 433).

The logic behind the golden rule is that, in the long run, price inflation reflects developments in ULCs<sup>7</sup> (Ghali 1999; Höpner and Lutter 2014). Thus, given that the monetary union is premised on a paradigm of price stability and sound money, stable ULCs developments are necessary in order to have national inflation rates converge around the common inflation target. This would be necessary to avoid endogenous destabilizing developments fostered further by the “one size fits all” (or better none) monetary policy of the central bank (Enderlein 2006, 114).

Considering that the ECB’s inflation target has been defined as a rate of inflation (the European Harmonised Index of Consumer Prices, HICP) below but close to 2% over the medium term, nominal wages at the national level would thus be required to grow in line with the 2% target plus the rate of labour productivity in the economy. In this scenario, all participants to the monetary union would enjoy the same rate of ULCs

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<sup>6</sup> Stephan Collignon and Willi Koll were the civil servants in the German Finance Ministry in charge of setting up the MED during the Germany EU-presidency in 1999 (Collignon 2009, 463, footnote 60; Koll 2005, footnote 59)

<sup>7</sup> See Höpner and Lutter (2014) for an empirical study on developments in the Eurozone and for further references on ULC as the main determinants of price inflation. Höpner and Lutter (2014, 13) find a correlation between ULCs and inflation of  $r = .83$ . See also Collignon (2009, 430, footnote 8) for a review of the economic literature on the topic and Watt (2007) for a formal conceptualisation.

growth and inflation over the medium run. Countries' trajectories would converge toward the price stability mandate and workers' share of national income would remain stable.

The adoption of the golden rule for wage bargaining was meant to engineer a "soft functional equivalence" for the lack of an institutionalised system of wage coordination across EMU members. Given the impossibility to resort to exchange rate adjustments, wage policy was given priority in the MED. Wage setting has since thought to be key in order to prevent asymmetric developments of countries' wage and price inflation from driving structurally divergent competitiveness positions and thus macroeconomic imbalances (Watt 2010). From a normative perspective, if respected, the golden rule provides also an analytical tool to reconcile the conflict between capital and labour and to transform it into a positive sum game. Targeting the inflation benchmark provides the floor which ensures protection of workers' purchasing power in the medium run. The productivity rate constitutes the ceiling within which non-inflationary wage increases can be achieved. The more the wage rate approximates the golden rule, the more the value created during the production process is shared equally between capital and labour and across the sectors of the economy. This implies redistribution of productivity gains from the more productive sectors of the economy to the less ones.

The relevance of wage policy for the macroeconomic governance of the EMU stems from its stabilizing capacity. Wage policy is important in the EMU because it is charged with two stabilizing functions. First, to avoid economic shocks which are endogenous to the wage setting system and will eventually result in the accumulation of competitiveness losses/gains, policy makers should correct deviations – in either direction (upward/downward) - from the golden rule of wage bargaining. This means correcting the trajectory of wage policy while deviations from the benchmark unfold. This would be a preventive type of policy action. Secondly, in the event of an exogenous shock, wage policy can serve stabilisation purposes tailored to the nature of the policy problem (i.e. either through reflation or deflation).

While this line of reasoning applies to wage policy in general, what has been often neglected so far is that the very nature of public sector wage policy makes it exponentially important in the EMU. Public sector wage policy *is* fiscal policy, the former being a subset of the latter. Since the fiscal resources necessary for public sector wage setting have to be eventually earmarked in governments' budget laws (Beaumont 1992), public sector wage policy is the only policy instrument in the political economy in which wage and fiscal policies coincide. Given that wage and fiscal policies are the only levers which remain in the remit of national authorities within the EMU, public sector wage policy is a unique policy instrument which enables governments to exploit them simultaneously for stabilisation purposes. For the EMU this also means that countries' coordination of public sector wage policy is intrinsically connected to that of fiscal policy. Public sector wage setting *shapes and is shaped* by fiscal policy.

Observing public sector wage policy unfolding therefore is also a fundamental way to observe governments' fiscal stance in a monetary union.

The importance of public sector wage setting cannot risk being over-emphasized. In fact, "the greatest single claim on the public purse today is its wage bill" (Rose et al. 1985, 1). This statement has not lost its significance over time. As an average of the EMU countries, compensation of public employees has remained rather stable over time, notwithstanding the two-decades long effort to reform and curtail public service employment according to the logics of the New Public Management (NPM) doctrine (Bach and Bordogna 2011; Pollitt and Dan 2011). As of 2013, the public sector<sup>8</sup> continues to employ on average 21.3% of total employees across the OECD developed economies (OECD 2015, 84). This means that regardless of the crisis of the tax state (O'Connor 1973; Streeck 2011) and of times of "permanent austerity" (Pierson 2002), public employment remains one of those "immovable objects" (Pierson 1998). Employment in public services is the core pillar of our mixed-market economies: as of today, around 1/5 of workers across the developed world continue to be employed by a public employer. The compensation of public employees as a percentage of GDP in the EMU stands at an average of 10-11% in the EMU (figure 2).

This makes public sector wage setting a key lever in the hands of national governments. After all, the idea that (big) governments could act as significant stabilisers in the economy is not new in the Keynesian tradition: Minsky (2008 (1986), 330) appropriately had it that "(B)ig Government is the most important reason why today's capitalism is better than the capitalism which gave us the Great Depression". If managed correctly, public sector wage policy could potentially serve governments' need for stabilisation. This is exponentially important in the EMU's constrained macroeconomic environment. Differently from the private sector where governments' interference is either constrained or prohibited (e.g. *Tarifautonomie* in Germany), public employers remain in more or less direct control of public sector wage policies by virtue of their sovereign prerogatives. Yet, since its inception, public sector wage policies of EMU member states have been found to be pro-cyclical and to have influenced private sector wage setting negatively, contributing to the competitiveness divergence across the union (Holm-Hadulla et al. 2010). As a result, public wages have been a key driver of macroeconomic imbalances in the EMU (Baccaro and Tober 2017; Johnston, Hancké, and Pant 2014).

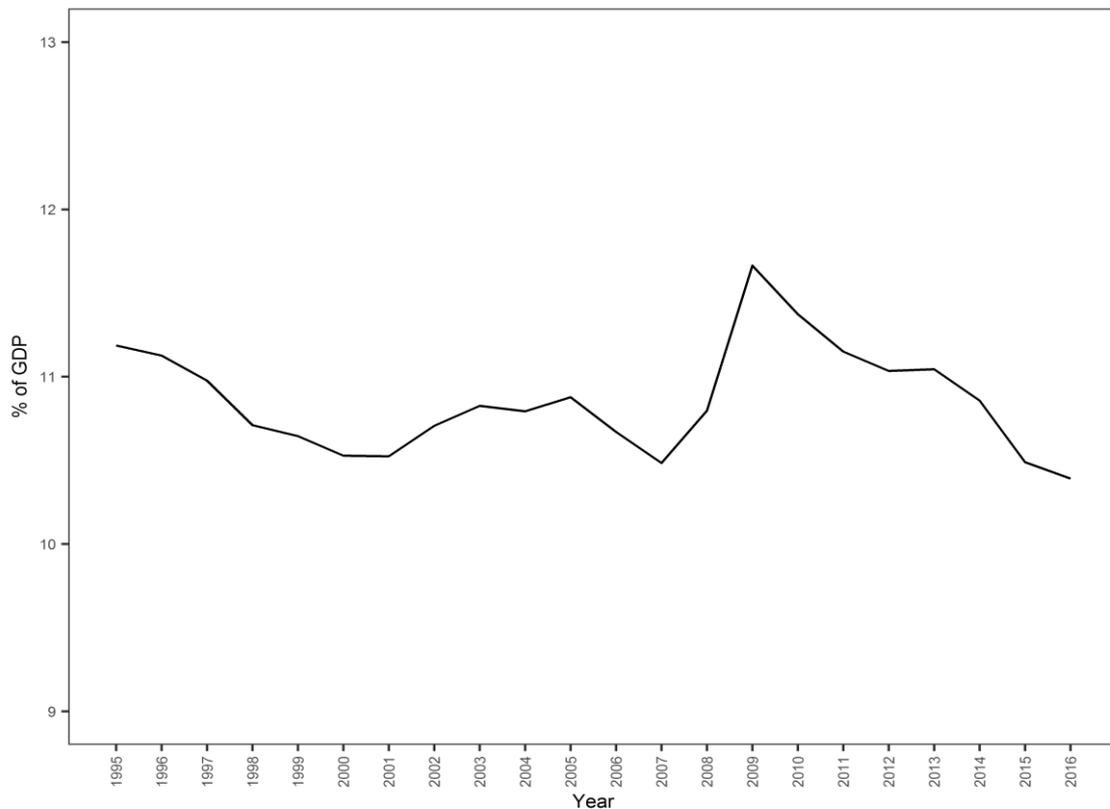
Ten years after the financial crisis, and twenty years after the beginning of the EMU, we are still far from having understood why have public sector wages diverged so drastically in the EMU and why have governments not tried to make "correct use" of public sector wage/fiscal policy to stabilise their economies. The puzzle of Germany's

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<sup>8</sup> The OECD definition of public sector includes employment in public corporations, i.e. legal units producing goods and services for the market but controlled and/or owned by government units (OECD 2015, 84).

public sector wage restraint, on which the following sub-section elaborates in greater detail, is a case in point.

Figure 2: Compensation of public employees as percentage of GDP, average of EMU countries (1995-2016)



Source: IMF, Government Finance Statistics (GFS). EMU=11

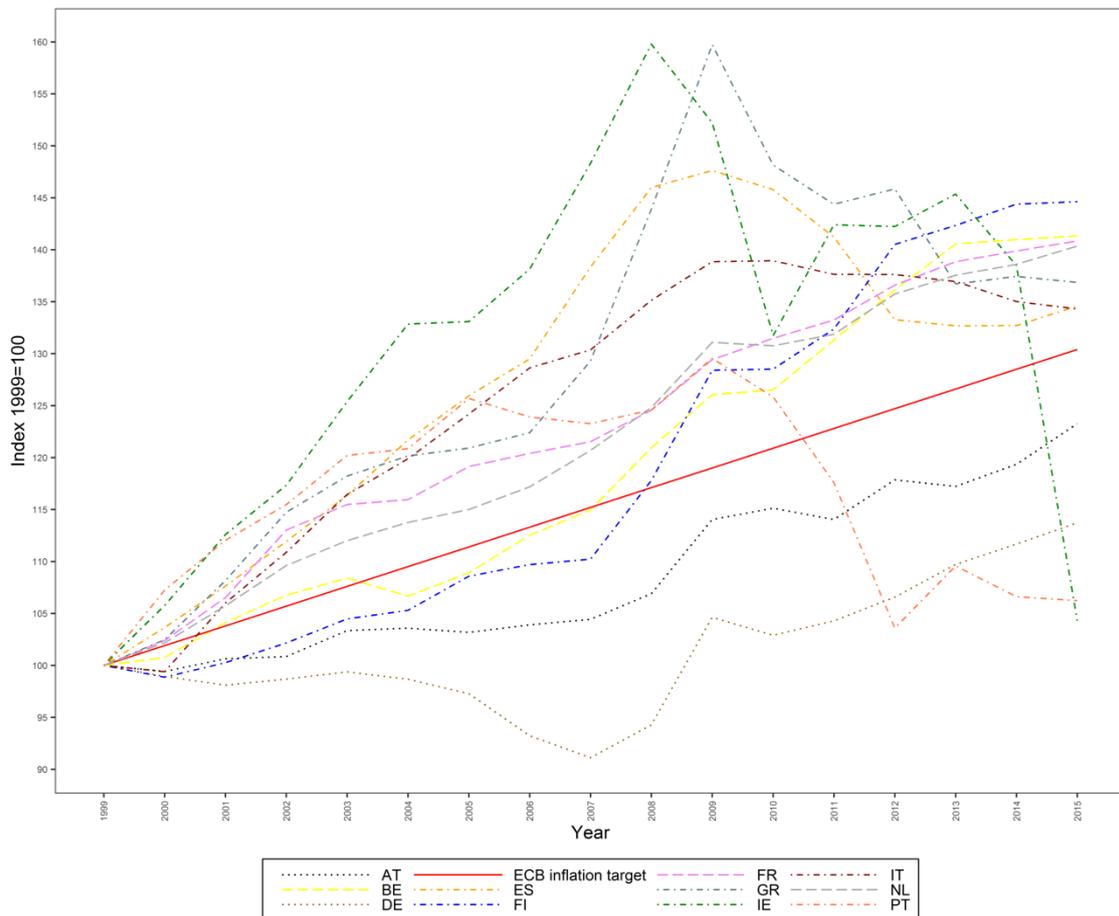
### 1.3 THE PUZZLE OF GERMANY'S PUBLIC SECTOR WAGE RESTRAINT

The puzzle this dissertation sets out to tackle can be fully understood if we consider two interconnected dimensions. One is empirical, the other theoretical. The former is related to the pattern of structural divergence in public sector wage setting which can be observed during the first decade after the creation of the EMU. The latter stems from our theoretical understanding of the German industrial relations system and the way in which academic works have until now interpreted sheltered sector wage restraint therein.

The empirical dimension pertains to the outcomes of public sector wage policies across the EMU members. Figure 3 shows the extent to which wage trajectories in the public sector have diverged after the introduction of the monetary union - a hard-currency regime based on an independent central bank and stable money. The broad picture shows that public sector wage setting has developed according to three main

trajectories. Countries at the periphery of the EMU have experienced remarkable public sector wage inflation. Germany has, for the most part alone, gone through an unrelenting trajectory of public sector wage restraint. Some other countries have wage developments more or less in line with the golden rule of wage bargaining introduced above. Interestingly, these trajectories take different patterns also within countries over time. So we observe that, after the inflationary peaks before the crisis, countries of the periphery have endured an internal adjustment which brought them more or less in line with wage developments in the core countries of the EMU. Germany shows a pattern of restraint throughout the period which, however, takes two different trends. Public sector wages have been pushed downward especially during the years 2004-2008. After the crisis wages have started to grow again and the trend seems to be more or less in line with the golden rule.

Figure 3: Trajectory of hourly compensation in the public sectors of EMU members (1999-2015)



Source: EU KLEMS database. \*Nominal wages are discounted by total labour productivity.

From macroeconomic theory we learn that an incomplete monetary union which does not fulfil the requirements of an OCA is made better off by the convergence of national wage trajectories around the golden rule of wage bargaining. Visually, this means that the countries' wage trajectories displayed in figure 3 should have shadowed the red line

indicating the ECB's inflation target because, in the long run, a country's price inflation reflects developments in its ULCs' inflation. Given that the EMU is premised on a paradigm of price stability and sound money, stable wage trajectories in line with the golden rule of wage bargaining are necessary in order to have national inflation rates converge around the common inflation target. This is desirable to avoid destabilizing developments which are then enhanced further by the EMU-wide asymmetric monetary policy of the ECB. Yet this has not occurred. Wage trajectories in countries' public sectors have diverged substantially. The general question to be asked therefore is: why have countries which were subjected to the same hard monetary regime experienced divergent trajectories of wage growth in their public sectors? To start finding the answer to this wider empirical question, this dissertation engages with the German case of public sector wage restraint displayed by the dotted line in figure 3. What explains Germany's trajectory of public sector wage restraint vis-à-vis its EMU peers?

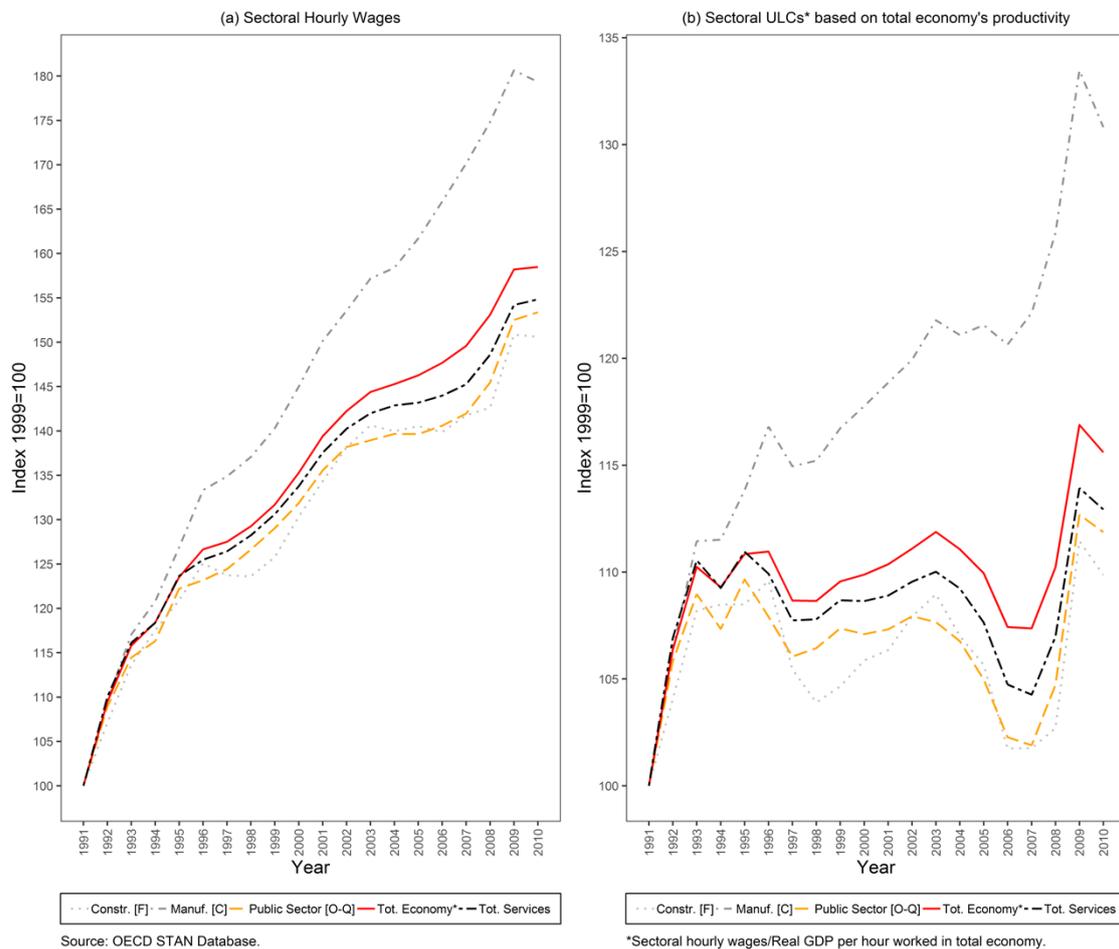
While empirically interesting due to its extreme values on the phenomenon to be explained, the German case study opens up a further dimension in the puzzle which is theoretical in nature. In explaining public sector wage trajectories, scholars working in the tradition of public choice economics would posit that an outcome such that of public sector wage inflation is likely to be the result of self-interested politicians' office-seeking nature and the exploitation of public budgets for private electoral gains. Great are in fact the opportunities for political actors to engage in collusive behaviour with rather powerful public sector trade unions. Political exchanges (Pizzorno 1978) may lead, through public sector wage setting, to the creation of mutually beneficial "distributive coalitions" (Olson 1982). Indeed, politicians and public employees alike may be capable of exchanging consensus for generous public sector wage increases, at the expenses of the common good – and the public coffers. Still, a public choice explanation cannot be applied to a case of severe public sector wage restraint like that observed in Germany. Moreover, the presence of cross-country and within-country variation which can be observed suggests that institutional heterogeneity and environmental factors are crucial tiles which are likely to help us solving the puzzle.

In fact, a large body of literature in the field of institutionalist CPE has explained policies of public sector wage restraint through the presence of effective wage bargaining institutions which ensure wage coordination between exposed and sheltered sectors of the economy. Given that moderation is in the self-interest of wage setters who need to remain internationally competitive in the export sector, anchoring public sector wage setting to the export sector's ensures the transmission of restraint throughout the economy. According to these arguments, the observed divergence across the EMU countries' public sector wage trajectories ought to be explained by the presence/absence of effective wage bargaining institutions of the like described.

Within this literature, Germany has been considered by both CPE and industrial relations theory as the prototypical case for such a type of export-led inter-sectoral wage coordination which runs under the heading of export-led pattern bargaining. This

and other theoretical aspects will be addressed thoroughly in due course. Suffice it to say here that what can instead be observed in Germany is rather a *de-anchoring* of sectoral wage trajectories. Since the mid-1990s public sector wage growth has substantially lagged behind that of the export sector. Rather than two sectors shadowing each other through inter-sectoral wage coordination, figure 4 shows “dualization” within the German economy. Manufacturing wages have continued to follow an upward trend while service sector wages, and most notably public sector wages, have stagnated. How could such divergent trajectories come about if wages in the export and public sectors were effectively anchored to each other via a pattern bargaining type of inter-sectoral wage coordination?

Figure 4: Indexes of hourly wages in different sectors of the German economy (1991-2010)



Di Carlo (2018a) has in fact challenged this type of institutionalist explanation based on export-led pattern bargaining both on theoretical and empirical grounds. This work constitutes the starting point for the investigation to be pursued in this dissertation. In fact, it has been shown that inter-sectoral wage coordination can no longer be considered a valid theoretical explanation for public sector wage restraint. The explanation is refuted in the very prototypical case on the basis of which the theory was

popularised. Therefore, if we cannot explain Germany's public sector wage restraint through the theory of inter-sectoral wage coordination via export-led pattern bargaining, what other factors, so far unaccounted for, explain Germany's trajectory of public sector wage restraint?

The dissertation will tackle the empirical and theoretical puzzle of public sector wage restraint in Germany's public sector. Solving this puzzle has practical relevance for policy making in the EMU in that a necessary precondition for addressing structural divergence of wage trajectories in the monetary union is to understand the domestic political and institutional factors which drive this divergence. Addressing the German case is but one step in this direction. Of more theoretical relevance for scholars of CPE and industrial relations should instead be the fact that the German case of public sector wage restraint conforms to the conditions of a crucial case study. Germany is, in other words, a case in which an established – and dominant – theory fails to explain the outcome of interest in the most likely case in which we should expect to theory to be valid. Solving the puzzle of public sector wage restraint in Germany is thus likely to help us refine and improve our wider understanding of both Germany's industrial relations and, more generally, public sector industrial relations and wage setting beyond the German case.

#### *1.4 BRIEF EXCURSUS ON DEFINING THE PUBLIC SECTOR*

The wage policy options conceptualised above are to be studied in the arena of the public sector. Given substantial differences with regard to what the public sector means in different countries, it needs to be defined in a way that eliminates confusion.

Defining the public sector is not easy and definitions often depend on the analytical point of view adopted by the researcher. Similarly, availability and quality of public sector data varies across time and nations (Hammouya 1999). Some definitions are derived by considering the organisations that collectively constitute government and include in the public sector all those activities funded by public money or carried out by either elected officials or by appointees of an elected government (Rose et al. 1985, 3). These definitions, however, tend to include both public services (the public sector proper) and public enterprises (the para-public sector), those market entities owned wholly or in part by public authorities.

The treatment of public enterprises is, however, a major challenge to producing accurate definitions of the public sector (Beaumont 1992, 8). Distinguishing between the public and the para-public sector within and across countries is an extremely complex task since definitions and classifications differ significantly from one country to another and are often formulated in general terms (Gernigon 2007, 1). Some countries (e.g. France and Portugal) for instance include state-owned enterprises in the public sector, while other do not (Vaughan-Whitehead 2013, 2). Furthermore, there is

variation with regard to the types and diffusion of public enterprises across countries with disjointed and incomparable data.

Since the purpose of this dissertation is circumscribed to the study wage setting in the public services, it is fruitful to adopt a circumscribed definition of the public sector which only looks at the public services provided by the state. Taking the cue from previous research (Johnston 2016, Appendix I; Johnston, Hancké, and Pant 2014; Vaughan-Whitehead 2013), I approximate the public sector by aggregating the following categories from the International Standard Industrial Classification of All Economic Activities (ISIC): *public administration and defence plus compulsory social security (Category O)*; *education (P)*; *human health and social work activities (Q)*.

Two caveats are of order with regard to public sector employment. The first refers to the distinction between states and markets. Organisations providing core services to the community may be public in the sense of being fully funded by taxpayers' money. Alternatively, services of public interest may be provided by private enterprises. In the latter case, given the private nature of the employment relation, the state as the public employer would not serve as a contractual part in wage setting. The dissertation deals only with public employees for which the state serves as the public employer. Therefore, when looking at real instances of public sector wage setting here, the focus of the case studies will be on processes of wage determination (be it through collective bargaining or state unilateral intervention) which affect public employees proper and for which the state funds wage setting via the public budgets. Related to this private/public dimension is the problem that the databases on which we must rely (e.g. Eurostat, OECD, EU KLEMS) often do not distinguish between market (private) and non-market (public) units. It has to be clear that when using these databases, data will have to be understood as just a proxy for the public sector. AMECO data on governments' expenditures for public personnel is instead a more accurate indicator of the public employers' expenditures in wage setting.

The second point relates to the structure of the state as the locus of public employment. All modern States, to different degrees, feature constitutionally-defined dispersion of political authority across different levels of government (e.g. federal, state and municipal) and among state agencies (Ferner 1988; 1995; Pollitt and Bouckaert 2017, 48). In the dissertation I will consider all levels of government in the definition of the public sector. This is generally referred to as general government in the national accounts.

## CHAPTER 2. METHODOLOGICAL STRATEGY OF THE DISSERTATION

This chapter is methodological in nature. Its function is to explain and motivate the choices made regarding the dissertation's methodological approach. The primary objective of this dissertation is to provide a *historical explanation* of a particular case of substantial interest. To do so, the dissertation will employ a two-step process tracing methodology. I blend together elements of deductive and inductive process tracing. As a first step in the explanatory effort, I proceed with theory testing process tracing to test the validity of extant explanations for the case at stake. Subsequently, and after having refuted the main alternative theory that explains the outcome of interest, I proceed with a more inductive type of outcome explaining process tracing. The chapter unfolds as follows. Sub-section 2.1 presents the rationale for selecting Germany as the single case study of the dissertation. Sub-section 2.2 elaborates on issues of methodology, motivating the choice made for the two-step type of process tracing. Sub-section 2.3 discusses the nature, origin and storage of the sources exploited in the work.

### 2.1 LOGIC OF CASE SELECTION: GERMANY AS BOTH AN EXTREME AND CRUCIAL CASE

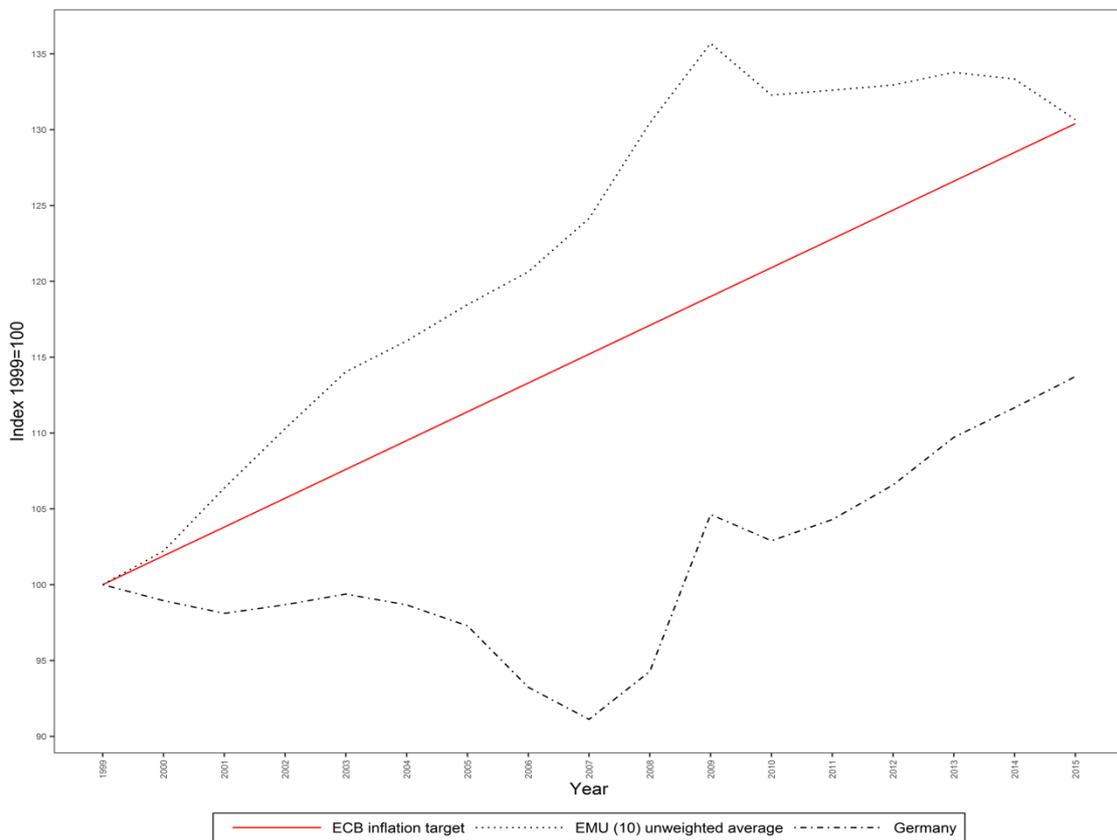
Quantitative research can rely on large samples whereby the selection of cases occurs through various techniques for randomisation. These techniques enable the selected cases to be fairly representative of an overall population. In case study research, instead, the sample is small, at times unique, making randomisation techniques unavailable. In the absence of this possibility, qualitative research must deal with alternative established practices for selecting the cases to be analysed. Several such techniques for choosing cases exist in the literature. (Gerring 2006; Ch. 5) enumerates no less than nine techniques for purposeful case selection on the basis of the case's properties. Germany has been selected as the single case study of this dissertation for three reasons.

First, Germany constitutes a case with substantial *real-world implications* (Mahoney and Thelen 2015, 13) which are *intrinsically important* (Van Evera 1997, 78), both to academic theory and to policy practice. Indeed, all public sectors matter, but some public sectors matter more than others. Germany is the most populous member of the EMU. It is the EMU's industrial powerhouse and key centre of political and economic power. Not least, Germany is the single biggest trading partner at the core of the single market. In the early 2000s, its weight in the HICP stood at a preponderant 31%, in contrast to France's 20% and Italy's 19% (Hancké and Soskice 2003, 158). Therefore, Germany alone makes for around 1/3 of the total weighting of the HICP which the ECB should, by mandate, keep at the target level. If we believe that Germany's undervaluation regime constitutes a nightmare for the very functioning of the EMU (Höpner 2019), then we should strive to understand the German case of public sector

wage restraint before formulating policy solutions of any kind. After all, with more than 4.5m public employees, public sector wage restraint constitutes a crucial sub-set of the overall trajectory of wage restraint in the German economy. This necessitates a stand-alone analysis of the German case.

Second, Germany satisfies the conditions for the study of an *extreme case*. The logic of this case selection is rooted in the necessity to explain cases which show extreme values on the independent or dependent variable of interest. It is the case’s “extremity” along the dimension of interest which confers methodological relevance to the case and not any other theoretical aspect (Gerring 2006). Thus, the operationalisation of public sector wage policies around the concept of the golden rule allows us to capture the extent to which Germany’s public sector wage restraint is both *extreme* (vis-à-vis its EMU peers) and rather *unique*. This can be appreciated by confronting Germany’s public sector wage restraint vis-à-vis the average of public sector wage developments in the EMU (figure 5).

Figure 5: Germany’s public sector wage restraint vis-à-vis EMU peers (1999-2015)



Third, and to the theoretical interest of students of CPE and industrial relations, Germany satisfies the conditions for the study of a so-called *crucial case* (Eckstein 2000). This method consists of selecting cases which “*must closely fit* a theory if one is

to have confidence in the theory's validity or, conversely, *must not fit* equally well any rule contrary to that proposed" (Gerring 2006, 115). Since it is rather difficult in practice to aspire to a perfect fit between theory and observation, "most-likely cases" and "least-likely cases" have been elaborated according to a similar logic. The former is a case which should, most likely, fulfil the predictions of an established theory, and yet does not. These types of cases are used to disconfirm theories. Least-likely cases are instead useful for confirming them. In fact, the contrary logic runs in the least likely case where a phenomenon is observed in cases in which, according to established theories, we should least expect it.

Germany constitutes a perfect most-likely case since established theories in CPE and industrial relations have explained public sector wage restraint with what will be termed "*the pattern bargaining hypothesis*". As anticipated, Germany has for long been, and continues to be, treated as the prototypical case of export-sector-led pattern bargaining. Indeed, institutionalised inter-sectoral wage coordination is one of the central institutional pillar which famously makes Germany a coordinated market economy (P. Hall and Soskice 2001). This theory has been popularised in CPE by the seminal work of Soskice (1990) and in industrial relations by Traxler, Brandl, and Glassner (2008). The dissertation will show that, although Germany is a most-likely case where to expect export-sector-led pattern bargaining to explain public sector wage restraint, the empirical observations are incongruent with the predictions of the theory. Evidence cannot be found to validate the theory. The empirical part of this dissertation will confirm that public sector wage setting in Germany had little to do with the export sector's. Therefore, we are left with the necessity to perform an in-depth case study to account for public sector wage restraint in Germany.

## 2.2 METHODOLOGY: A TWO-STEP PROCESS TRACING APPROACH

To pursue a historical explanation means to arrive at “inferences about the causes of specific outcomes in particular cases” (Mahoney, Kimball, and Koivu 2009, 116). These sorts of explanations are intended to account for outcomes “that have already happened, either in the distant past or in the recent past”. Thus the “goal of the analysis is precisely to explain the specific past occurrences; the question of whether and how the resulting explanation might then be generalised is a secondary concern” (*ibidem*). To “explain” in a historical manner entails the “explanation of a sequence of events that produce a particular historical outcome in which key steps in the sequence are in turn explained with reference to theories or causal mechanisms” (Bennett 2004, 21).

Within this research tradition, the scope is not to explain historical happenings by just listing descriptive facts. Rather, through the case study, the researcher aspires to account for “well-defined aspects” of a historical happening which have been selected for the analysis. These very aspects are what constitute the case to be studied. A case, therefore, is to be understood as “an instance of a class of events of interest to the investigator” (Bennett 2004, 21). A case study can be understood as “the intensive study of a single case where the purpose of that study is – at least in part – to shed light on a larger class of cases (population)” (Gerring 2006, 20). The case study method then consists of a within-case method of analysis in which the analyst must assess multiple sources of empirical evidence which may causally explain the case at stake.

As described in the previous chapter, the abstract class of events of interest here consists of the adoption of public sector wage policy. Going down the “ladder of abstraction” (Sartori 1970), three alternative types of public wage policies have been conceptualised. Of these, the class of public sector wage policy to be studied is public sector wage restraint. Within the context of the EMU monetary regime, Germany constitutes the most prominent instance of such a class of events. I situate the in-depth study of this case of public sector wage restraint within two critical junctures. I start the analysis from the reunification of West and East Germany in 1990 and terminate it with the financial crisis in 2008. The motivation for the choice to begin with reunification is based on *a priori* knowledge of the German case. In fact, Germany’s public sector wage restraint is a phenomenon deeply rooted in the economic and political developments of the mid-1990s. Reunification, in conjunction with other external factors, triggered the reconfiguration of processes, outcomes and institutions of public sector wage bargaining in Germany. Thus, a detailed historical explanation of the German case cannot avoid harking back to German reunification. The decision to terminate in 2008 will hopefully become clearer by the end of the dissertation. Besides the financial crisis, this juncture coincides with the establishment of a new institutional equilibrium in public sector wage bargaining which, I posit, is currently at play in the German political economy. This equilibrium has come into force since 2008 when the

two-fold process of institutional and constitutional change of public sector wage determination was fully completed.

The dissertation employs a process tracing qualitative methodology for within-case analysis. A problem with declaring to be doing some sort of process tracing is that there seems to be no univocal understanding of what process tracing means and how it shall be executed. In fact, Trampusch and Palier (2016) count more than fifteen different definitions of process tracing which have been used, either inductively or deductively, since the 1980s. While the literature on the topic has proliferated (Beach and Pedersen 2013; Bennett 2010; Falletti 2006; P.A. Hall 2013; Mahoney 2015), some of the distinctions which are highlighted in theory may however be less accentuated in practice.

Process tracing can conveniently be defined, following Bennett and Checkel (2015, 7), as “the analysis of evidence on processes, sequences, and conjunctures of events within a case for the purpose of either developing or testing hypothesis about causal mechanisms that might actually explain the case.” Thus, by executing a process tracing methodology, the researcher attempts to identify the causal process through which an initial factor or set of factors is linked to and produces the outcome to be explained. The researcher must identify both the causal chain and the causal mechanism which explains the outcome of interest. These explanations are then provided in the form of analytical sequences of events or causal chains which make explicit *how* factors located at different points in time contribute to an outcome to be explained (Mahoney 2015).

Accordingly, process tracing rests on the type of social science explanations based on causal mechanisms as opposed to constant conjunctions (Mayntz 2004). Again, several definitions and understandings of causal mechanisms exist (Hedström and Ylikoski 2010; Mahoney 2001). My ontological understanding of causality in the social and political world is aligned to that of scientific realists’ who put emphasis on causal processes and causal mechanisms as the central components of causal explanations. I understand causal mechanisms as being of a probabilistic nature. Hence, it is not assumed here that the same mechanism regularly produces the same outcome across time and space. Rather, mechanisms exert their causal influence probabilistically within environmental contexts and institutional settings over time (Falletti and Lynch 2009).

I look favourably to the pragmatic stance followed by Bennett and Checkel (2015, 12) who understand causal mechanisms as:

*“ultimately unobservable physical, social, or psychological processes through which agents with causal capacities operate, but only in specific contexts or conditions, to transfer energy, information, or matter to other entities. In doing so, the causal agent changes the effected entities’ characteristics, capacities, or propensities in ways that persist until subsequent causal mechanisms act upon them.”*

I concur with the authors that causal mechanisms are in some sense unobservable. They are entities and processes in the world, but it is through the theories and hypotheses in

our minds which we aspire to capture them. The researcher theorises about mechanisms and then tests the testable implications of these hypotheses against observable evidence. Explaining historical cases through causal mechanisms involves, as much as the case at stake allows, a commitment to conduct analyses at the lowest level of analysis and through the greatest degree of attainable details.

Process tracing can then be performed either deductively or inductively, although in practice all types of process tracing require an iteration process between theory and empirical evidence from within the case (Trampusch and Palier 2016). In deductive process tracing, the analyst infers predictions from available theories to then test them against a set of empirical observations. In the process, it is important to test predictions from a set of alternative explanations. This type of deductive process tracing gets very close to the *systematic process analysis* approach recommended by P.A. Hall (2006). As a first step, the researcher formulates a set of theories which identify both the principal causal variables thought to be conducive to the outcome to be explained and an account of how these variables interact in the causal chain which produces the outcome. In other words, these theories shall identify not only the crucial causal variables but also the process through which these exert causal force upon the outcome. The researcher must elaborate a set of at least two or more alternative theories which can be tested against empirical observations. Hall's proposition is based on the "three-cornered-fight" (Lakatos 1976) among a theory, a rival theory, and a set of empirical observations. As a second step, for each of the theories elucidated, the researcher derives predictions about patterns that should be observed in the real world, were the theory to be valid. Predictions shall be formulated in a way that makes them testable against collectable data and clearly distinguishable from the predictions of competing rival theories. In the third step, the researcher performs observations of the real world which are pertinent to these predictions. An observation consists of data obtained through whatever way is appropriate for maximizing the available evidence, whether documentary research, interviews or computation. Lastly, observations drawn from the cases are compared with the predictions of the theory with the purpose to reach a conclusion on the merits of each rival theory. Such a conclusion is based on the congruence between the predictions formulated for each theory and the observations collected for the case.

The very strength of this method lies in the possibility to amass a multitude of different types of data from different types of sources and thereafter execute multiple observations and tests of the theories. These include specific actions performed by various actors as well statements by these actors on the reasons why they performed such actions and, in general, all sorts of observations helpful to establish the validity of a formulated prediction. However, the limitation of applying a "pure" systematic process analysis approach in this dissertation lies in the fact that, as it will be shown, there is but one theory in the literature which has engaged properly with explaining public sector wage restraint in Germany. This is what I have called the "*pattern*

*bargaining hypothesis*” which I consider as the main “rival explanation” to be tested in the dissertation. Through a theory testing procedure like that recommended by Peter Hall, I have refuted the theory as incongruent with the empirical evidence. As a result, in the process, I have been left with an “undertheorized historical outcome” that needs to be explained without reference to any well-grounded existing theory. This necessarily implies an element of induction be introduced side by side next to a deductive process tracing methodology.

In the effort to open “the black box of causality” through inductive process tracing, the researcher should be willing to bring in “unexpected clues or puzzles that indicate the presence of left-out variables” (Bennett 2004, 24), leading to the development of new hypotheses through which social science can advance. On the basis of the extensive knowledge I have acquired on the German case, I have decided, perhaps pragmatically, that the best (and most transparent) way to present the research conducted is through a two-step process tracing methodology. This includes both a deductive element of theory testing process tracing and a subsequent inductive element of outcome explaining process tracing.

In the first step (chapter 3), following recommendations of best process tracing practices (Bennett and Checkel 2015, 25), I “cast the net widely” in the search for alternative explanations. I review critically four different strands of literature in the social sciences: economics, interest-based CPE, industrial relations and institutionalist CPE. The aim is two-fold. First, the interest is in taking stock of how the subject of public sector wage setting and collective bargaining has been treated in the social sciences more generally. Here I have found that, in the first three mentioned fields, only indirect insights can be derived. While going through each of these sub-sections, I will take good care of discussing why these insights remain only partial and unsatisfactorily for present purposes.

Second, the interest is in deriving alternative explanations for the German case. Here I have found that a set of works has specifically dealt with the case of interest. Hence, I dedicate the whole sub-section 3.5 to test predictions from this theory against a set of empirical observations. This exercise has led me to the conclusion that the empirical observations are incongruent with the predictions of the pattern bargaining hypothesis. As a result of this failure, I have moved toward theory-guided process tracing (Falleti 2006). The epistemological interest was more of an inductive nature here. However, I have let my induction be driven, informed and disciplined by a theory frame (Rueschemeyer 2009) assembled by putting together pertinent knowledge in different strands of the social sciences. Indeed, “good process tracers need good theory so that they know where to focus their analytical attention, which actors to study and interview and what historical sequences to analyse” (Trampusch and Palier 2016, 14). This is precisely what I attempt in chapter 4 where I formulate an alternative state-centred institutionalist framework for the study of public sector wage setting. This framework shifts the theoretical lenses onto the complex wage setting role public employers play

within the contours of the state's institutional contextualisation. The framework puts emphasis on the very fiscal nature of public sector wage setting and urges us to think of public sector wage policy in terms of the politics of fiscal policy and political interrelations among various state actors.

Together with other scholars engaged in institutionalist analyses of social, political and economic phenomena, I believe that “causal effects depend on the interaction of specific mechanisms with aspects of the context within which these mechanisms operate” (Falleti and Lynch 2009). Coherently with this credo, I theorise about an institutional setting within which public sector wage setters interact in the process of wage determination. I bring in four institutional domains which, I hypothesize, shape these policy interactions. I present the theoretical reasons for *why* and *how* these institutional domains matter in shaping processes and outcomes of public sector wage setting.

The analytical framework advanced will most likely not reach the status of a full-fledged theory. But this is not my ambition. More modestly, the framework is meant to discipline the inductive explanatory process. It is meant to do so by providing a theory-grounded understanding of which actors matter, how and when they matter and in which way the environmental and institutional context provides incentives and constraints to the actors involved in the adoption of public sector wage policy.

### *2.3 NATURE, ORIGIN AND STORAGE OF THE UTILISED SOURCES*

This section introduces the reader to the different types of data which have been collected and utilised for the study of the German case. To comply with the “transparency revolution”, as recommended by the best practices of process tracing (Trampusch and Palier 2016), I have organised all the data (both the evidence directly cited and other material not cited) through the software for qualitative analysis MAXQDA. This has enabled me to divide and organise the data in a way that is coherent, intelligible, chronologically-organised and easily accessible by a third party.

The result of this logistic effort is a MAXQDA file which will be stored, together with a backup of the material, in the servers of the *Max Planck Institute for the Study of Societies (MPIfG)*, in Cologne. The file can thus be accessed and consulted upon request. Due to an agreement which I have stipulated with my interviewees, all the interviews are anonymised in such a way that only the institutional affiliation can be recognised. The data I have collected is divided in primary and secondary sources. Primary sources are sources which provide first-hand testimony or direct evidence of the historical phenomenon under investigation. Secondary sources are those which instead interpret and analyse the phenomenon after it has occurred. I have relied on a triangulation of different types of primary and secondary sources which I have

collected before, during and after my work on the field. Table 1 provides a snapshot of the sources used.

*Table 1: Types of empirical sources utilised*

	<b>Documental Sources</b>	<b>Interviews</b>
	Archival, physical sources: <ul style="list-style-type: none"> <li>- <i>ÖTV archive (Bonn)</i></li> <li>- <i>Ver.di archive (Berlin)</i></li> <li>- <i>Ministries' documents and reports</i></li> </ul>	
<b>Primary Sources</b>	Statistical: <ul style="list-style-type: none"> <li>- <i>AMECO</i></li> <li>- <i>Destatis</i></li> <li>- <i>EU KLEMS</i></li> <li>- <i>OECD</i></li> </ul>	Elite Interviews: n. 19
	Archival, digital sources: <ul style="list-style-type: none"> <li>- <i>Eurofound archive</i></li> <li>- <i>EIRR archive</i></li> <li>- <i>WSI Tarifarchiv</i></li> <li>- <i>OECD yearly economic surveys</i></li> <li>- <i>EIU's country reports</i></li> <li>- <i>IMF's yearly country reports</i></li> </ul>	
<b>Secondary Sources</b>	Newspaper coverage: <ul style="list-style-type: none"> <li>- <i>Financial Times Historical Archive</i></li> <li>- <i>Lexis Nexis</i></li> </ul> Academic yearly reports: <ul style="list-style-type: none"> <li>- <i>Political Data Yearbook, Germany's yearly accounts</i></li> </ul>	Expert Interviews: n. 8

During the period comprised between spring 2016 and the summer of 2017, I have embarked on a tour throughout Germany during which I have conducted twenty-seven interviews. Some of these interviews were conducted at a later stage to clarify aspects which, after concluding the historical reconstruction, still seemed unclear. I have conducted interviews with experts on both fiscal policy and public sector industrial relations in Germany. These were considered secondary sources. The interviewees whom I interviewed as experts were mostly professors with an established record of related publications. Alternatively, they were practitioners who work or have worked on the issues of interest in research institutions or policy institutions. Next to expert interviews, I have conducted several elite interviews which I have considered as primary sources. In fact, by the word elite I mean persons who had an actual position of power in the processes being studied. These interviewees either participated directly in

the processes studied or were closely involved. These actors were interviewed in relation to the institutional role they hold or held within the organisations involved in these processes. To ensure a balanced sample, I have made sure to interview actors representing different organisations standing on different sides of the process of public sector wage setting. As a result, the interviewee sample covers actors from the Federal Finance Ministry, from the organisations for employers' representation at the municipal and Länder level and from different trade unions organisations. Unfortunately, I did not manage to get to interview representatives of the Federal Ministry of the Interior. A list of interviewees is provided in the appendix (A) at the end of the dissertation. All the audio files of the interviews are stored within the MAXQDA file.

Next to interview data, I have collected statistical data from multiple sources. Data from the *EU KLEMS* database provides information on wages at the sectoral level. Similar information could be found through the *OECD Stan database*. The *AMECO* Database of the European Commission provides additional data on public spending on government employees' compensation. Data on public employment and financial issues, decomposed at the level of Länder and municipalities, could be found on the German Federal Statistical Office (*Destatis*). The collective bargaining archive of the Institute of Economic and Social Research (*WSI*) in Düsseldorf provides detailed information on collectively agreed wage increases at the sectoral level. All the datasets and the coding files (in the *R software*) are uploaded within the MAXQDA file.

In order to acquire information on political, economic and contingent historical developments, on a yearly basis, I have collected several institutional reports. These constitute documented evidence. Here I will mention only the most important ones which have been exploited extensively in the writing of the case study. Available from the year 1992, the yearly edition of the *Political Data Yearbook*, edited by the *European Journal of Political Research*, has been a very precious source to obtain information about key political and social events on Germany on a yearly basis. Similarly, the *Economist Intelligence Unit's* country report on Germany has provided valuable information on political and economic facts on a yearly basis. This publication was available only for the years 1996-2008. The OECD's yearly economic surveys and the IMF's yearly country reports provide accurate and detailed statistical data and analysis on both political and economic developments on a yearly basis. In the specific, these have been precious sources to analyse in detail the developments in the realm of fiscal policy in Germany. Via the *Financial Times'* historical archive, which I could access through the infrastructure of the MPIfG, I could download the newspaper's coverage on issues related to fiscal and wage policy in Germany. Not surprisingly, given the importance Germany's economy, the *Financial Times* has covered extensively both issues related to fiscal policy and wage negotiations in both the export and public sector. Through the software *Lexis Nexis*, accessed via the MPIfG, I could also download thousands of newspaper articles in both the German- and English-speaking press, which have covered through the years the wage negotiations in the

public sector. All this material – and much other not mentioned here - is divided by source, organised chronologically on a yearly basis and stored within the MAXQDA file.

With regard to data on wage bargaining negotiations, I could access different sources. The *WSI's Tarifarchiv* provides comprehensive documentation on wage bargaining processes and outcomes in conjunction with contextual political and institutional factors. However, reports were only available from the year 1994. The archives of the *Eurofound* provided much documentation reporting on wage setting and employment relations more generally. These were available only from the year 1997 onwards. I have complemented this document-based evidence with the use of the monthly reports of the *European Industrial Relations Review* (EIRR). The MPIfG holds copies of this industrial relations physical archive<sup>9</sup>. This was one of the most important documental sources I could rely on when studying events of public sector wage setting in Germany on a monthly basis. The EIRR provides detailed information on issues related to any sort of relevant happenings in the realm of employment and industrial relations. This gives monthly information which covers all the countries of the European Union spanning a time horizon of about thirty-five years (1970-2006). All of this material is divided by source, organised chronologically on a yearly basis and stored within the MAXQDA file. The EIRR archive is physical and remains stored in the library of the MPIfG.

Lastly, I have personally spent time in the physical archives of the old ÖTV trade union and the newly formed Ver.di. The German-language documents of the ÖTV are contained within the *Archive of Social Democracy Archive of the Friederich-Ebert Stiftung* in Bonn. I visited ÖTV's archive during June 2017. In the archive I could find first-hand documentation related to the operations of the trade union during the years 1990-1998. Most of these documents are in hard copy and stored personally. However, only very few of these documents have been directly used and cited in the dissertation. With regard to documentation concerning the Ver.di trade union, I had the chance to consult the internal archive in the Ver.di's Berlin headquarter in summer 2017. I paid several visits to the archive where, however, most of the documents of my interest were still classified.

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<sup>9</sup> Indeed, I am extremely grateful to Susanne Hilbring and all the other extremely professional employees of the MPIfG's library for having supported me throughout the process.

### **CHAPTER 3. CASTING THE NET WIDELY: GERMANY'S PUBLIC SECTOR WAGE RESTRAINT AND THE STUDY OF WAGE DETERMINATION IN THE SOCIAL SCIENCES**

This chapter is theoretical in nature. Its function is to take stock of the available literature to examine the way in which the subject of public sector wage setting has been dealt with in allied subfields of the social sciences. In the sub-sections which follow, I zoom in on various branches of economics (sub-section 3.1), of CPE (3.2 and 3.4) and of industrial relations studies (3.3). The analysis of the literature reveals that the public sector proper has been either neglected or marginalised to the fringes of these disciplines. This appears especially true for the study of public sector's wage setting and industrial relations. With this awareness in mind, I have thus extended the analysis to other pertinent works. Although not directly engaging with public sector wage setting, I have selected works which carry interesting theoretical insights for the specific German case at stake. In the process, I have made an effort to consider these scholars' reasoning and I have tried to extend the implications of their wider arguments to the specific case of public sector wage restraint in Germany. From their reasoning, I have derived other plausible alternative hypotheses on which to reflect before arriving at the central rival explanation for public sector wage restraint in Germany. In sub-section 3.4 I engage critically with institutionalist CPE since it has dealt extensively with the study of wage setting and industrial relations. In sub-section 3.5 I conclude the chapter by testing empirically the validity of main alternative explanation for the case of public sector wage restraint in Germany: "*the pattern bargaining hypothesis*". By refuting this rival explanation, I prepare the ground for chapter four in which I outline an alternative state-centred analytical framework.

#### *3.1 ECONOMICS*

The public sector lies at the core of public economics. It is since the work of its founding father - Richard Musgrave - that the discipline has engaged with questions related to the intervention of governments in the market economy. Musgrave (1959) posited that modern governments intervene in the economic systems through the famous "three branches": stabilisation, allocation and distribution. With the first, the government was called on to ensure that economy would remain at full employment with stable prices. With the second, the government intervened in the way the economy allocated its resources. It did so directly by buying goods and indirectly by taxing and/or subsidizing the private sector. Lastly, the government was concerned with the way in which the wealth produced in the economy would be distributed in society in relation to issues of equity and efficiency.

Central to the interest of public finance scholars has been the acknowledgment of private sector's limitations in the capacity to produce efficient outcomes and meet the social needs of the community. From this, it followed the necessity for governments to intervene in the economy to mitigate market failures and ensure the production of public goods which would not be adequately supplied nor efficiently produced by private enterprises. Scholars thus study the nature of government intervention in the economy, the causes and effects of this intervention in different institutional contexts and policy areas and the most adequate and efficient "means" for the government to interfere with the functioning of private markets.

Yet in the most prominent and recent textbook on the economics of the public sector (Stiglitz and Rosengard 2015), over more than nine hundred pages, there is hardly any mentioning of public employees' compensation and their centrality in governments' expenditures. In the discipline, governments' outlays are mostly analysed in terms of their social functions, namely expenditures for defence, education, health, social protection, etc. The lack of interest for employees' compensation is astonishing considering that, as shown in one figure of the textbook itself, expenditures for public employees range from more than 15% of GDP (out of a total of 54.1% ) in Sweden to about 6% of GDP (out of 41.8%) in Japan (Stiglitz and Rosengard 2015, 46; figure 2.7 (data for 2009)).

Public choice has emerged as a parallel sub-field which has tried to construct a bridge between political science and economics. Central to public choice is the assumption, formulated in the social choice theory (Buchanan 1987) that government action is the result of politicians acting rationally in their own self-interest and in response to the political rules of the game. The perspective of public choice turned the assumption of public finance on its head. While in the latter the benevolent government of altruistic politicians would enact policies that enhance the collective welfare of society, public choice saw self-interested politicians governing for the purpose of extracting personal gains<sup>10</sup>. Nordhaus (1975) has famously argued that incumbent governments engineer political business cycles. They increase budget deficits so as to stimulate the economy in proximity of elections to reap electoral benefits, shifting the costs into the future. Others have elaborated economic models<sup>11</sup> based on opportunistic politicians "illuding" naïve voters incapable of coming to terms with the technicalities of fiscal policy (Buchanan and Wagner 1977); models on inter-generational and intra-generational redistribution through fiscal policy (Cukierman and Meltzer 1989; Tabellini 1991); models in which by raising debt, incumbents try to tie the hands of future governments to gain an electoral advantage in future elections (Alesina and Tabellini 1990); models with "war of attritions" games in which fiscal adjustments in the polity are delayed

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<sup>10</sup> I am thankful to Fritz Scharpf for this intuition to which he led me during private conversations.

<sup>11</sup> For a survey of the economic literature on the "Political Economy of Budget Deficits" see Alesina and Perotti (1995) and Alesina and Perotti (1996) for the more specific literature on the impact of institutions on budgetary policy.

indefinitely due to distributional fights between two political forces in power with opposing interests and electoral bases (Alesina and Drazen 1991; Drazen 1996); etc. What these public choice models have in common is that they are geared toward explaining instances of fiscal expansion or delayed fiscal adjustments (at the expenses of the taxpayers' money). As such, these models appear unfit for explaining the German case of marked wage/fiscal restraint.

In a different sub-field, labour market economists have focused on the structure and level of public sector wages in comparison to the private sector. Most of the literature<sup>12</sup> tries to track down the presence of private/public sector wage differentials and to quantify them while keeping constant personal characteristics (e.g. education levels, gender, etc.) or other labour market and collective bargaining institutions. In different sauces and to different extent, the literature seems to be more or less unanimous in identifying a so-called “public sector wage premium” (Giordano et al. 2011; Lucifora and Meurs 2006; Panizza 1999; Postel-Vinay 2015; Postel-Vinay and Turon 2007). The gist of this literature is that the wage gap in favour of the public sector increases at the lower tail of the wage distribution while it turns negative at the higher tail. Put it differently, the jobs performed by low-skilled workers are paid better by a public employer as opposed to the private sector. On the contrary, the high-skilled jobs with managerial responsibilities are paid more generously in the private sector. In all, to the best of my knowledge, labour market economists have *not* produced models to account for the adoption of public sector wage policies.

Within the sub-field of post-Keynesian macroeconomics, a group of scholars have produced a type of economic explanation for Germany's wage restraint which brings with it an interesting ideological twist. For these scholars, economy-wide wage restraint in Germany is to be attributed to the obsessive *Ordoliberal*<sup>13</sup>, or *anti-Keynesian* (Jörg Bibow 2018), economic ideology guiding German policy makers in the implementation of a purposeful strategy of economic Mercantilism (Cesaratto 2013). According to this line of argument, Germany pursues a form of economic imperialism rooted in the pursuit of trade surpluses vis-à-vis the rest of the world (Flassbeck and Lapavitsas 2015, 32). This is an explanation based on a prevalent “*economic ideology*” in which cognitive elements affect decision making in economic policy. This explanation sees policy outcomes as the result of national traditions and values which decision makers hold in relation to the economy.

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<sup>12</sup> For an extensive survey of the literature see Giordano et al. (2011).

<sup>13</sup> On Ordoliberalism in Germany and austerity more in general in the context of the financial and sovereign debt crises in America and Europe see Blyth (2013). For works on Ordoliberalism in Germany see Beck and Kotz (2017), Hien and Joerges (2017). For a critical assessment of the argument on the ordoliberal origins of Germany's role in the EMU (Matthijs 2016) see Hien and Joerges (2018). On the clash of economic philosophies between France (discretionary-based policy making) and Germany (rule-based policy making) in the EMU see Brunnermeier, James, and Landau (2016).

Works along these lines advance what can be termed as the “*Ordoliberalismus hypothesis*” (Cesaratto and Stirati 2010). Famously, Flassbeck and Lapavistas (2015) argue that wages and ULCs were “hardly ever mentioned” during the debate which took place in Germany in the run up to the EMU. The “ideological debate” across Europe revolved around fiscal policy and the perils of inflation where Germany managed to impose its “dogmatic monetarist tradition” centred on price stability. The German government, flanked by the employers, applied “vigorous” pressures on labour unions to reduce nominal and real wages. This move was guided, the authors argue, by their belief in the “flexibility doctrine” of the labour market and it was “grounded in the neoliberal conviction that lower wages would result in more labour-intensive production processes across the economy” (2015, 22). As a result of this offensive, “Germany systematically undershot the target” of the golden rule, operating a policy of “begging-thy-neighbour” after “begging its own people” by “essentially freezing wages” (2015, 25). This led to macroeconomic imbalances which were not rectified in the EMU because their “macroeconomic implications were ignored due to the doctrinal and theoretical obsessions discussed” and because of the lack of adjustable exchange rates (2015, 33).

It is necessary to reflect critically on these accounts for this type of macroeconomic *cum ideational* account bears theoretical implications. In fact, from these arguments we could *indirectly* derive a sort of alternative hypothesis worth considering further. Seen from the lenses of the “*Ordoliberalismus hypothesis*”, we may be tempted to interpret Germany’s public sector wage restraint in terms of the government’s specific economic ideology. German governments should thus be seen as repelling budget deficits and, most importantly, pursuing strategically wage/fiscal restraint and labour market flexibilization in order to ensure price competitiveness and an undervalued REER. Such an undervaluation strategy enables them to sustain a mercantilist economic model based on export-led growth. The advantage of such an explanation may probably lie in its parsimony and intuitive plausibility. Formulated in this generalised way, the causal story can be easily digested and there would hardly be anyone who disputes the peculiar German aversion to budget/trade deficits and inflation. Yet explanations along these lines suffer from several pitfalls which make this hypothesis not fully satisfactory.

In disagreement with these arguments, it must be observed that it was the German Presidency of the EU which, during the Cologne European Council in 1999, set up the Macroeconomic Dialogue (MED) recommending the golden rule of wage bargaining as the formal policy guideline to be followed by national social partners. This was meant exactly to avoid structural divergence of inflation rates and macroeconomic imbalances in the EMU. *Prima facie*, this crucial fact appears immediately incongruent with the hypothesis advanced by these post-Keynesian macroeconomists. It is rather difficult to prove that “ideological policy makers” were not aware of and ignored the implications of ULCs developments in a single currency. Quite to the contrary, it was two German

civil servants<sup>14</sup> working in the German Finance Ministry who proposed the adoption of this soft form of wage coordination across the EMU (Collignon 2009, 433).

Secondly, their narrative does not match the timing and the sector-specific trajectories of wage growth across the German economy. The argument that wage restraint in Germany “coincided with the formal introduction of the monetary union” (Flassbeck and Lapavitsas 2015, 23) appears incorrect. As the case study will show in great detail, wage restraint had already emerged in the early 1990s, as a consequence of the Bundesbank’s decision (in July 1992) to raise interest rates to unprecedented levels after the reunification’s inflationary boom. When EMU was launched in 1999, wage restraint was well under way. Most importantly, since reunification, wage restraint has been pursued disproportionately in the sheltered sectors of the German economy (figure 4). What has in fact been neglected is that, since the mid-1990s, restraint has been even more pronounced in the public sector (Di Carlo 2018a).

Therefore, the most crucial problem with these generalised macroeconomic grand narratives is that they fall short of explaining the divergent trajectories of sectoral wage growth within the German economy (figure 4). Not taking sector-specific interests and institutions seriously weakens their arguments. A large body of literature in CPE tells us that actors operating in sectors which are sheltered from international competition have different interests, pursue different strategies and engage in different political struggles than export-oriented producers’ coalitions (Crouch 1990b; Frieden 2014; 1991; Hancké 2013; Johnston and Hancke 2009; Pontusson and Swenson 1996; Swenson 1991). Thus, it remains very difficult to pin down and tell the ideational from the material without a conceptualisation of sectoral interests and their institutional peculiarities. Economic ideology alone falls short of explaining inter-sectoral divergence in the German economy. For these accounts to be fully convincing, agency and structure would need to be nested together in a more refined understanding of how ideology-driven actors have secured power to transform economic ideologies into diverging policy outcomes in a context of conflicting interests.

As a matter of fact, wage restraint and preoccupation for international competitiveness is easily understandable for both employers and trade unions in the export sector. Here, it may very well be the case that economic ideology and interests are aligned, leading to the emergence of a cross-class coalition. In the public sector we can’t reasonably expect workers and unions to go along smoothly with a two-decade-long pattern of wage restraint. Why should we expect public workers to tolerate a pattern of restraint that serves the interests – and possibly the ideology – of the exporting employers and the government? Under the realistic assumption that public sector workers long for improvements in their purchasing power just like any other worker, we should rather

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<sup>14</sup> Stephan Collignon and Willi Koll were the civil servants in the German Finance Ministry in charge of setting up the MED during the Germany EU-presidency in 1999 (Collignon 2009, 463, footnote 60; Koll 2005, footnote 59).

expect conflict and contestation to trump ideology. For these scholars to convince us that the German employers (or the government for that matter) have imposed a strategic pattern of mercantilist restraint on the whole economy, they will have to convincingly show us the mechanisms through which the domestic sector has been co-opted by the export sector.

As a last resort, it may be argued by these scholars that it was the government, guided by a specific set of economic ideologies, that “started to put political pressure on labour unions in an attempt to restrict the growth of both nominal and real wages” (Flassbeck and Lapavistas 2015, 22). However, given *Tarifautonomie* in the German system of private sector collective bargaining, this argument seems plausible only with regard to public sector wage setting. In fact, as the case study will show, the German government did apply enormous pressures to reduce the fiscal costs of public sector wage setting. But this was never meant to be instrumental to a strategy of economic mercantilism. It was a pragmatic strategy of fiscal consolidation in hard times. In fact, these scholars’ narrative comes across as too simplistic. Talking about “the German government applying political pressures” cannot explain wage restraint in the public sector for the very essential reason that Germany is a decentralised federal state in which political authority in important policy areas is assigned primarily to the States which compose the Federation (Katzenstein 1987, 15-35). In fact, Germany is a “semisovereign” state, characterised by a fragmented polity, consensus-based politics and an intricate system of fiscal federalism. This carries the non-negligible implication that, especially in matters of public sector employment relations and wage setting, the “federal government has no choice but to negotiate and cooperate with centres of state power over which it has no control” (Katzenstein 1987, 16). There is, in other words, not a single government or public employer in Germany whose interests and ideology coincide smoothly with those of the federal government. Neither is there a single centre of power which export elites can easily capture. The whole dimension of intra-public sector conflicts of interest is ignored by these scholars with the result that the German government is, incorrectly, treated as a monolithic bloc capable of unitary action. A more nuanced analysis of the German political economy reveals, instead, a great influence of the institutions of cooperative federalism on policymaking and the presence of distributive conflicts between layers of governments together with asymmetries between the West and the East (Benz 2008; 1999).

### *3.2 INTERESTS-BASED COMPARATIVE POLITICAL ECONOMY*

Works in CPE fall within three different types of approaches, namely ideational, interest-based and institutions-based explanations (P.A. Hall and Taylor 1996). Without intention to disparage ideational/cultural approaches, it is fair to say that when studying wage bargaining and industrial relations, CPE scholars have mostly privileged interest-based and institutionalist approaches. Explanations of political and economic

phenomena have relied fundamentally on the material interests of principal actors and/or institutional structures as key explanatory variables. It is, however, not always easy to clearly tell the interests dimension from the institutional one in CPE. Since institutionalist explanations will be the object of extensive discussion in sub-section 3.4, here I focus only on interest-based approaches and leave the discussion of the former to a later stage.

Interest-based approaches generally proceed by identifying the material interests of principal actors to then trace the way in which power is configured through political alliances so as to translate preferences into favoured policy outcomes. Actors are understood as either individual or composite, the latter taking the form of associations or corporate actors (Scharpf 1997b, Ch. 3). By prioritizing material interests over alternative explanations (e.g. ideational), these works tend to start by asking who benefits (*“Qui bono?”*) from the policy being implemented and how actors’ material condition would be affected by it (Gourevitch 1986, 56). Actors’ preferences are shaped by their specific material condition in the economic or political arena - a process of preference formation perhaps best exemplified by the adage: “where you stand depends on where you sit” (P.A. Hall 1993, 275).

Explanations centred on producer groups are central to the CPE discipline. These works generally concentrate on associations of economic actors whose preferences are determined by the specific position they occupy in the process of value creation in capitalist economies. As units of analysis, broad societal groups have often been derived on the basis of various distinguishing factors (P.A. Hall 1997, 176): for instance with regard to the actors’ relationship vis-à-vis the means of production (e.g. capitalists, workers, financial rentiers and landowners) or in relation to sector-specific interests (e.g. exposed vs sheltered sectors), and so on. Key to these specifications is the implication that political alliances will be forged to mobilise collective actors - of different nature but with similar interests - behind given policy packages. Situation-specific policy coalitions can thus emerge *within* different segments of the capitalists’ camp, according to specific business interests. Moreover, coalitions can emerge *across* the labour/capital divide, taking the form of cross-class coalitions where the interests of a specific subset of capitalists coincides with those of a specific segment of the working class (Pontusson and Swenson 1996; Swenson 1991).

The distinguishing feature of this approach lies in the belief that “policy requires politics” (Gourevitch 1986, 17), which is to say that if a policy is to be implemented it must advance the interests of specific socio-economic groups in the political economy. It also implies that, when material conditions change, regardless of the driver of change, the interests of principal actors would change, triggering actors’ reaction in the quest for the reconfiguration of political coalitions in support of newly preferred policies. What characterises the production profile explanation is that the material interests of producer groups acquire precedence over political actors. Producer groups hold specific preferences for policy and assemble political coalitions to *capture* the

political arena in order to arrive at desired outcomes. The arrow of causality thus moves from the economic onto the political arena, which producer groups must successfully capture.

To the best of my knowledge, no such works directly engaged with public sector wage setting. However, within this sub-field, the literature on dualization and liberalisation of Germany's labour markets and industrial relations bears interesting insights (Baccaro and Benassi 2016; Hassel 2014; Thelen 2014). Faced with the problem of increased competition in international markets, German industrial relations, it has been argued, have gone through a process of dualization which led to an unprecedented insider-outsider division between a manufacturing core and the remaining service economy which was subjected to cost cutting and liberalisation measures (Hassel 2014). Stable and cooperative industrial relations between capital and labour have been maintained in the core manufacturing export sector where firms "appreciate the advantages of dealing with strong and unified bargaining partners" and have retained a "continued commitment ... to traditional institutions and social partnership" (Thelen 2014, 47-58). Employers in the export sector have thus defended industry-wide bargaining and preserved peaceful relationships with strong unions to keep distributional conflicts "off the shop floor" and obtain flexibility within the existing bargaining structures (e.g. through short time work to avoid layoffs). At the plant level, cross-class cooperative relationships have become stronger through firm-level cooperation between managers and the works councils who share a strong interest in the firm's success.

Liberalisation trends have instead led to the erosion of wage bargaining institutions and unionisation rates in the service sector, leading to a process of dualization through drift whereby labour compensation in services has declined remarkably vis-à-vis wages in the export core, leading to the increase of income inequality in Germany (Thelen 2014, 54-58). Hassel (2014) argues that liberalisation in services is functional to strengthening coordination and competitiveness in the export core. Baccaro and Benassi (2016) argue that, in fact, the export sector has "thrived at the expense of real wage stagnation" in labour-intensive service sectors. They posit that, since exports of machinery and transportation equipment (the engines of the German export industry) have become price-sensitive, producers' groups in the export sector have set in motion a process of cost reductions and liberalisations necessary to maintain cost and price competitiveness in international markets. Slightly in contrast with the other views, they argue that processes of erosion and liberalisation have occurred also in the manufacturing core. The resulting wage restraint has spurred a transformation of the German economy into an export-led growth model (Baccaro and Pontusson 2016). At any rate, these authors seem to agree that this process of liberalisation at the margins has been driven by producer coalitions of export-oriented firms and core workers' representatives. These specific dynamics in German industrial relations should be seen in the context of a more generalised process of liberalisation in European industrial

relations which has increased employers' discretion pushing unions on the defensive (Baccaro and Howell 2011; 2017).

Although these works entirely disregard the public sector in their treatments of the service sector, some implications can nevertheless be derived but must *not* be directly imputed to these scholars. Following the logic of the argument, one may remain under the impression that, as an alternative explanation, wage restraint in the German public sector could be a by-product of the necessity of the manufacturing export sector to prevent domestic inflation (of ULCs and of prices) which erodes REER competitiveness in world markets. In fact, Baccaro and Pontusson (2016) do not shy away from advancing this type of argument in their interpretation of the German case. An explanation of this kind would conform to the classic "*production profile explanation*" in CPE whereby social groups in key economic sectors mobilise and apply pressures to capture governments and obtain policies which conform to their economic interests.

From the analysis of these scholars' insights, one can *indirectly* derive what could be called the "*export-sector domination hypothesis*". It is interesting to notice in this respect that similar arguments will be shown to be at the core of institutionalist CPE approaches to German industrial relations reviewed below (sub-section 3.4). We would thus be better off understanding these types of arguments as complementary. In fact, the "*export-sector domination hypothesis*" and "*the pattern bargaining hypothesis*" shall be thought of as two facets of the same overarching dynamic. More precisely, institutionalist works in CPE have, through the study of labour market institutions, worked out the alleged institutional mechanism through which interests-based CPE accounts claim the dominance of the export sector elite in the German political economy. In fact, both arguments would buy into the fact that, export sector domination in the German economy takes place in the industrial relations arena via inter-sectoral coordination of wage bargaining. According to this line of argument, negative inflationary spill overs in the public sector are prevented via inter-sectoral wage co-ordination led by the export sector. Through this institutional mechanism, a self-interested cross-class coalition in the export sector constitutes a sort of "dominant social bloc" capable of imposing its export-related interests over processes and outcomes of public sector wage setting. Thus, pattern bargaining shall be understood as the instrument (or the mechanism) through which a dominant elite in the export sector yields control over the Germany political economy.

While thoroughly informative, a key drawback of this literature is that the segments of the service sector which they refer to are the "low-end services" (retail trade, hotels and restaurants, other personal services) (Baccaro and Benassi 2016, 102). The dualization literature tends to either fully neglect the public sector or to treat it in the same way as the "low-end services". This neglects the fact that the public sector is the biggest sector of the economy which remains under more or less direct control of political employers. It is a sector which features on average more skilled employment, high collective

bargaining coverage and trade unions' density rates (Bordogna and Pedersini 2013). Besides, millions of public workers, next to providing essential public goods to the community, have also the capacity to sanction their political employers' decision through the ballot box. Thus, the public sector is not akin to the low-end services.

### 3.3 INDUSTRIAL RELATIONS

Industrial relations is a field characterised most prominently by a concern for the classic subject matter of trade unions. It is a discipline with a natural tendency to focus most prominently on the labour/unions' side<sup>15</sup>. Actor-centred studies have focused on topics like the formation and reproduction of trade unions, their internal and external structures, unions' strategies and their effect on business, the economy and society (Boxall 2008; Fiorito and Jarley 2008). Another dominant topic has been the study of industrial conflict, its origins, its explanatory factors and the implications for the political and economic system (Crouch and Pizzorno 1978). Scholars have tried to measure the number of industrial disputes, the number of workers going on strike and the total number of working days lost during conflicts with the employers (Edwards and Hyman 1994; Shalev 1992). Unions' collective identity and its political significance in the context of industrial conflicts has been analysed by Pizzorno (1978). Other significant topics in the literature include the effects and determinants of collective bargaining structures (Flanagan 2008) and patterns of institutional change therein (Glassner, Keune, and Marginson 2011; Marginson 2015; Sisson and Marginson 2002). Surely, employers' strategies, resources and organisations have been analysed both from a theoretical and comparative perspective (Traxler 2004; 2008). Yet rarely can one find industrial relations scholars interested in the public sector, let alone the public employers. Most of the studies analyse developments in the nature and evolution of actors, organisations and institutions in the private sector, taking predominantly the trade unions' side as central focus of the analysis. As argued by Keller (2005a), labour relations in the public sector is a "traditionally ignored topic" in German industrial relations studies, and beyond.

The classic and most influential industrial relations model, the one developed by Dunlop (1993 (1958)), was a system which conceived of three actors, namely the collectively organised workers, employers and state bureaucracies. These actors would interact within a "web of rules" governing their relationships under the influence of three key external factors: technology improvements, product and factor markets and the distribution of power in the wider society. The model has been highly criticised for two reasons which, exactly for present purposes, make it unfit for the study of public sector industrial relations. Dunlop's critics have pointed at his model's determinism and have rejected his hypothesis of technological change as the primary driver of

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<sup>15</sup> I am thankful to Berndt Keller for this suggestion given to me during private conversations.

convergence of industrial relations systems across countries. Furthermore, scholars have criticised his understanding of the industrial relations system as a “discrete sub-system” detached from politics and governments’ policies (Heery 2008). Indeed, a model based on technological change as a key factor structuring industrial relations appears immediately unfit to study the public sector. The essential services-to-the-people (e.g. education, care, social work, etc.) which are produced by public employees, in fact, necessitate human interactions that cannot easily be the object of major productivity-enhancing technological change (Baumol and Bowen 1965; 1966). Furthermore, a discrete distinction between the industrial relations system and the political arena cannot, by definition, be made if the public employer is the state’s sovereign authority.

The role of the state in industrial relations has without doubt interested industrial relations scholars. It has been argued by some that States are not neutral actors in industrial relations (Howell 2005). In his study of the British trade union movement Howell argues that unions’ power, membership and strategies were primarily shaped not by technological change or the market context but rather from the policies of the British government. On a similar vein, in a more recent work, Howell (2016) argues that States have become more interventionist in industrial relations so as to favour the liberalisation of employment relations institutions. The way in which the state intervenes in industrial relations has been theorised by different scholars. Traxler (1999, 57) identifies three ways through which the state intervenes in industrial relations: it is itself an employer in the public sector; it makes the laws which regulate working conditions; it defines and regulates the formal framework for industrial relations. Hyman (2008, 264) classifies seven key respects in which the state affects national industrial relations regimes: as an employer in its own right; through defining and delimiting the status of other actors and the rules of the game; by legislating individual employment rights; by shaping the labour market through macroeconomic management; through supply-side labour market policies; through the maintenance of the welfare state; through the matrix of ideas of citizenship and the rights linked to it.

Thus the role of the state as a public employer has been acknowledged in the literature. Masters et al. (2008) develop a theoretical framework for the study of the state as an employer. They point at the central role of public financing as mediating factor in public sector industrial relations and the fact that environmental contexts of different sorts (economic, political-legal, social-demographic, technological) influence public employers’ governance decisions. However, they mainly focus on privatisations and outsourcing dynamics as drivers behind the downsizing of the public sector, i.e. they do not put their framework into action. Similarly, Ferner (1994) concentrates on the state as employer but mostly in the context of state restructuring along the lines of NPM reforms. Empirical studies on public employers have not followed. A noteworthy exception is the comparative study of public sector employment regimes by Gottschall et al. (2015). They provide both a cross-country statistical analysis and in-depth

comparative case studies of various sub-sectors (Energy Regulatory agencies, waste collection and the Police) in Germany, France, Sweden and the United Kingdom. Their findings are interesting. In terms of public employment, contrary to the usual claim of state downsizing, they find only minor reductions in both common law and civil law countries while even a slight increase in public employment in the Scandinavian countries. Governments' employment compensation as percent of GDP is found to be on a slight declining path overall, indicating that many governments have been able to contain wage increases and stabilise public employment. Regarding employment regulation and personnel policies, they find that the three countries analysed have been reforming in the direction of the UK model based on private law regulation of public employment, position-based recruitment and performance-related pay and promotion – although with cross-country and cross-sectoral variations.

These types of analyses focused especially on trajectories of institutional change and state transformations have been at the core of a sub-field within industrial relations studies. Here scholars have extensively focused on *public sector employment and industrial relations*. What this literature rightly stresses is the distinctiveness of the public sector and its own logics and historical trajectories. A central theme revolves around the study of reforms inspired by the NPM agenda. Similar to debates taking place in private sector industrial relations (Katz and Darbishire 2000) and CPE (Crouch and Streeck 1997; Yamamura and Streeck 2003), researchers in comparative public sector employment relations began to ask whether patterns of convergence across national institutional systems can be observed also in the public sector (Bach and Bordogna 2011; Bach et al. 1999; Bach and Della Rocca 2000; Pollitt 2005; Pollitt and Bouckaert 2017; 2011; Pollitt and Dan 2011).

As a reform agenda, NPM emerged out of a more general shift from a Keynesian to a monetarist macroeconomic regime which brought with it a shift toward market-driven public services (Bach and Bordogna 2016, 6). Given pressures from producers to maintain lean taxation regimes under the now-credible threat of relocation (Schäfer and Streeck 2013) and due to the decline of the spectacular rates of economic growth which had characterised the Golden Age of post-war capitalism (Crafts and Toniolo 1996; Eichengreen 2008, Ch. 9), nation States found themselves increasingly confronted with the crisis of the tax state (Streeck 2011) and concerned with the sustainability of public finances. The incapability of raising sufficient revenues to meet the requirements of generous welfare States and the need to avoid harsh political confrontation with the recipients of these services made the politics of the welfare state a matter of great salience (Pierson 2001). Although originating in liberal market economies (UK, USA, Australia and New Zealand), during the 1980/90s the NPM paradigm spread among policy makers across the advanced world, sponsored by the OECD and consulting firms (Bach and Della Rocca 2000). Needless to say, the idea of making the public sector more efficient and effective by simply making it more similar to the private sector, found fertile soil with policy makers in need to reduce the size and control the cost of

the public sector. NPM was hailed as a way to cope with the fiscal crisis of the state (Barzelay and Gallego 2006) and as a “useful myth” to underpin processes of institutional isomorphism (Pollitt 2001).

The key tenet of the NPM reform agenda is to eliminate the distinctiveness of the public sector through the adoption of techniques, practices and values prevalent in the business sector (Hood 1995). In terms of public sector employment relations, national systems came to be challenged by dynamics of privatisation and marketization which aimed to make public employment similar to the private sector and expose public organisations to competition, incentive structures and accountability for results. Notwithstanding similar pressures for convergence, scholars in comparative public employment relations continue to highlight the resilience and distinctiveness of public sector employment systems. Variation across countries and in different parts of the public sector continues to remain (Alonso, Clifton, and Díaz-Fuentes 2015), even with regard to dynamics of public services outsourcing (Mori 2017) and in spite of the pressure exerted on public sectors by the austerity measures which followed the financial crisis (Bach and Bordogna 2016). In general terms, thus, scholars seem to agree that legal, institutional and administrative factors have exerted – and continue to exert – a considerable impact on national trajectories of reform. These reforms have been mediated by national path dependencies and have, at best, resulted in processes of institutional change through *layering* whereby new elements of the NPM agenda were added to old structures (Bach and Bordogna 2011), often with perverse unintended consequences (Bordogna 2008).

By way of conclusion, the study of British public sector industrial relations by Beaumont (1992) must be mentioned as the queen exception in the field. It is the first and foremost study of public sector industrial relations in a meaningful sense. It included the study of political and fiscal factors shaping the adoption of wage policies, while analysing the government as a public employer. Beaumont highlighted the *political environment* and the role of *strategic choice* by the government in public sector industrial relations. Public employers, he argues, are motivated not only by concerns for employment relations, but especially by *values* and *macroeconomic considerations*. Beaumont argued that the state should not be seen as “just a neutral representative of the public or social interest in industrial relations” but rather as a “separate, self-interested party in the industrial relations arena” with a degree of “relative autonomy which increases considerably in periods of economic crisis” (1992, 15). Emphasis was put on the fact that, during the 1980s in Britain, major changes in public sector industrial relations and wage policies resulted from governments’ strategies for macroeconomic stabilisation. In fact, Margaret Thatcher’s fight against inflation, of which public sector wage restraint was part, had little to do with narrow labour-related considerations. In this context, the government sought to enforce wage restraint via restrictive public sector incomes policies with the purpose of deflating the economy and to provide an example of wage restraint to the private sector. When

studying in detail the institutions and processes proper of the British public employment Beaumont thus concludes that “the direct role of economic forces in public sector wage determination is fairly limited” (1992, 142) due to the remoteness of product market forces, the difficulty of measuring productivity in many parts of the public sector and most importantly the different *ability to pay* which characterises public and private employers. The precious insights of Beaumont’s work will be embraced in the analytical framework developed in chapter 4. I now turn to works within the tradition of institutionalist CPE.

### *3.4 INSTITUTIONALIST COMPARATIVE POLITICAL ECONOMY*

Institutions-oriented explanatory approaches in CPE tend to assign the primary causal factors behind given phenomena to the organisational structures of the political economy. The attention to political institutions is a longstanding feature of the study of politics and, also in comparative analysis of capitalism, it has constituted the mainstay of the CPE discipline (Clift 2014 Ch. 5). Scholars in the institutionalist tradition emphasize how institutional differences across national, regional, or sectoral systems result in distinctive patterns of economic performance and policy (P.A. Hall 1997, 180). Thus, key to the institutional approach is the necessity to show both “which institutions matter and how they matter” (P.A. Hall and Taylor 1996) in order to demonstrate how structural variables or organisational features play a causal role in shaping the strategies and goals actors pursue and the decision making process (Thelen, Longstreth, and Steinmo 1992).

Institutionalist approaches to the study of wage policies have been at the core of CPE since its very inception, in the 1960s. The link between CPE and wage bargaining institutions was established already in Andrew Shonfield’s “modern capitalism” who conducted a comparison between the Swedish and the Dutch experiences with centralised wage bargaining (Shonfield 1965, Ch. 9, Sections 2-3). Shonfield noticed that centralised wage bargaining between peak organisations in Sweden was conducive to egalitarian practices of wage solidarity which reduced wage dispersion across different sectors of the economy. In the Netherlands, the government purposefully intervened in wage bargaining by setting artificially low wage ceilings (by decree law) aimed at keeping wages below those of their Western-European competitors.

Since then, various theoretical innovations have been developed by scholars working at the crossroad between CPE and industrial relations. During the 1970/80s, scholars focused on neo-corporatist wage bargaining institutions capable of incorporating responsible organised groups in processes of centralised economic policy making (Lehmbruch and Schmitter 1979; Schmitter 1974; Streeck and Kenworthy 2005). This, it was found, was conducive not only to lower inflation and unemployment rates (Bruno and Sachs 1985; Crouch 1990a; Tarantelli 1986), but also to the quiescence of the labour force (Cameron 1984). Calmfors and Driffill (1988) added at a later stage

that better macroeconomic performances could be obtained not only via centralised wage bargaining between peak associations, but also in fully decentralised systems with firm-level bargaining in atomistic labour markets. In his critique of wage bargaining centralisation, Soskice (1990) influentially maintained that rather than the *locus* of wage bargaining, what matters for successful macroeconomic policy making is effective inter-sectoral wage co-ordination across different bargaining units in the economy. Garrett and Way (1999) then suggested that when public sector unions capture peak level confederations, wage bargaining tends to create inflationary externalities that are conducive to worse economic performance. On a similar vein it has been argued that economy-wide wage coordination, when led by the sectors exposed to international competition, outperforms other wage bargaining arrangements under a system of fixed exchange rates (Traxler and Brandl 2012; 2010). This is because trade unions in the sheltered sector do not immediately bear the consequences of above-productivity wage gains. Given that employers in these sectors are shielded from international competition, they can pass wage increases on to consumers in the form of higher prices without losing market shares (Crouch 1990b).

During the 1990s, wage bargaining started to be studied also in conjunction with monetary policy and the role of independent and conservative<sup>16</sup> central banks. These were the days in which delegating monetary policy to a non-majoritarian institution ranked high among economists' policy proposals to curtail politicians' opportunistic behaviour at the expense of the taxpayers' community (Alesina and Gatti 1995; Alesina and Tabellini 1988; Cukierman 1992; Persson and Tabellini 1993). While joining the debate, political economists argued that independent central banks could produce lower inflation, without the cost of higher unemployment, only in interaction with co-ordinated wage bargaining across the economy (P.A. Hall 1994; P.A. Hall and Franzese 1998; Scharpf 1991; Soskice and Iversen 1998). The rationale behind the argument built on the institutionalisation of a particular signalling game between wage setters and the central bank. The model example on the basis of which the argument was originally formulated was the German Bundesbank, yet the general logic runs through the following elements. Independence enhances the credibility of the central bank by freeing macroeconomic adjustment from electoral considerations. Conservatism is required so that the central bank reacts directly and decisively to deviations from its inflation target. Signalling is necessary to communicate the central Bank's intended strategy and it is made more effective in interaction with co-ordinated wage bargaining because the central bank engages in interactions with just one economy-wide

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<sup>16</sup> Conservative is taken to mean a central bank which is inflation-averse ( $\beta > 1$ , where  $\beta$  is the degree of inflation aversion of the central bank in the central bank loss function). An inflation-averse central bank attaches more importance to being away from the inflation target than from the equilibrium output. An inflation averse central bank has a reaction function which is different from an unemployment averse central bank ( $\beta < 1$ ) or a balanced central bank ( $\beta = 1$ ). See Carlin and Soskice (2009, 34-35) or Carlin and Soskice (2014, Ch.13) in this regard.

coordinated wage settlement to which the other wage setters in the economy are subdued.

Thus, given that the wage settlement applies to the whole economy, wage setters are not left in much doubt that in case of inflationary wage setting the independent and conservative central bank will act as gate keeper and react by tightening monetary policy prompting higher unemployment and the appreciation of the exchange rate. Since export-oriented wage setters are particularly damaged by such reaction, by conducting the pilot agreement in the economy they internalise the effects of an inflationary behaviour and frame their wage requests in such a way to avoid the reaction of the central bank. This is usually done, they claimed, via exchange of information on the fundamentals of the domestic and international economy between the principal negotiators and with the central bank.

In terms of the interaction between traded sector and public sector's wage setting vis-à-vis monetary policy, Franzese (2001, 105) argued that "central-bank independence, coordinated wage/price-bargaining, *dominant* traded sectors and *dominated* public sectors are generally substitutes in producing low inflation and complements in producing low unemployment". In other words, "(C)ordinated bargaining most reduces unemployment when traded-sector actors dominate public-sector actors, especially when monetary policy is controlled by a conservative and credibly independent central bank" (Franzese 2001, 141). One can clearly see how interests-based and institutions-based approaches mingle together within the Varieties of Capitalism inspired research agenda of CPE.

At any rate, a theoretical problem then emerged when, with the creation of the EMU in 1999, monetary policy was delegated to the supranational level. Given the incapability of the ECB to selectively punish domestic wage setters, scholars questioned the capacity of the new monetary regime to produce wage restraint in the absence of pan-European wage coordination (P.A. Hall and Franzese 1998; Soskice and Iversen 1998). During the 1990s, in fact, two mechanisms had been at work to ensure that wage setters would internalise the inflationary effects of their actions (Hancké and Soskice 2003). The first was related to the signalling game between central banks and wage setters, as described. The second was the process of monetary integration in Europe and the hard fiscal constraints the Maastricht treaty imposed on wage setters and governments. As a matter of fact, candidates were required not to exceed the average inflation rate of the countries with the three lowest inflation rates plus 1.5%. This challenge was met by countries via lower nominal wages increases engineered either via coordinated wage bargaining or via tripartite social pacts (Hancké and Rhodes 2005). Unions, employers and governments converged behind the common goal of deflating their economies to join the EMU. In the single currency, however, both incentives and constraints disappeared, institutionalizing a new idiosyncratic wage setting environment with no incentives for restraint.

As a result, the shared expectation emerged that EMU would institutionalise a more inflationary setting due to three factors: the breakdown of the domestic interactions between central banks and wage setters; the lack of a pan-European infrastructure capable of replicating wage coordination at the supranational level; the unlikelihood of significant structural reforms which would decentralise wage bargaining to the firm level and make labour markets more flexible. The predictions of CPE scholars, however, did not become reality during the first decade of the EMU. Across-the-board inflation did not occur and the Eurozone taken as a whole has shown an orderly decade. The ECB was able to meet its inflation target (see also Carlin and Soskice 2014, 432-33) and, ironically, Germany has gone through an unprecedented trajectory of wage restraint in the private and especially in its public sector (Müller and Schulten 2015).

During the good times of the Euro the study of wage setting dynamics was somehow side-lined only to acquire again centre stage again after the crisis, when scholars identified structural divergence of wage setting as one of the main culprit behind the sovereign debt crisis. Rather than across-the-board inflation, in the monetary union the policy problem became the intra-EMU divergence in wage setting outcomes. Two blocs have emerged whereby the Northern countries, capable of maintaining wage restraint after EMU accession, have enjoyed REER competitiveness and trade surpluses. The countries of the EMU periphery, due to inflationary wage setting, have gradually lost competitiveness vis-à-vis their trading partners and accumulated trade deficits until the sovereign debt crisis hit them (P.A. Hall 2012; Iversen and Soskice 2013; Scharpf 2011). Some have maintained that the very functioning of EMU is endangered by the divergence of ULCs and the resulting trade deficits, denouncing the poisonous pattern of wage restraint in Germany (Flassbeck and Lapavistas 2015; 2013). In effect, Germany has undergone a sustained internal devaluation *vis-à-vis* its Euro partners. Surprised by the unexpected restraint and by the overall pattern of wage divergence between the two blocs, scholars have brought the old institutionalist insights on wage bargaining back to life.

Johnston and Hancke (2009) adopted a dual-sector approach to re-consider the interactions between exposed and sheltered sector wage setting in the absence of national monetary policy<sup>17</sup>. In explaining structural divergence among EMU members they point at the key role of heterogeneous wage bargaining institutions. Countries which have successfully managed to tame wage inflation in the sheltered sector also avoided negative spill overs on the competitiveness of the exposed sector. By enjoying lower inflationary pressures, these countries benefitted from a more advantageous REER, gaining competitiveness and piling up trade surpluses as a result. The key of the argument is that core countries of EMU enjoy an institutional comparative advantage in the production of wage restraint. This is thanks to wage bargaining institutions which

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<sup>17</sup> Several other works have developed very similar arguments. See e.g. Johnston (2012), Johnston and Regan (2014).

ensure effective inter-sectoral wage coordination needed to temper inflationary pressures in the sheltered parts of the economy.

Hancké (2013) argues that in the export sector wage setters are prevented from opting for inflationary wage setting by concerns of competitiveness in the international markets. Thus, ULCs in the tradable sector remained stable. In the sheltered sector, for which the public sector is taken as a proxy, such pressures are absent, paving the way for unrestrained claims on wage settlements. The key intervening variable for the transmission of wage moderation from the exposed to the sheltered sector is the type of inter-sectoral co-ordination in the wage setting system. Two main mechanisms are identified. One is state led co-ordination and the other is export-sector led inter-sectoral co-ordination, *i.e.* pattern bargaining (e.g. Germany). In a similar analysis Höpner and Lutter (2014) agreed with the overall findings but pointed at the fact that there has actually been variance in ULCs also within the export sectors of the countries which lack effective intra-sectoral wage coordination institutions (*e.g.* Italy).

So far, I have reconstructed the intellectual origins of the study of wage setting in CPE. The review of the literature demonstrates that CPE is mostly a discipline with the export sector at its core. Unfortunately, CPE is a discipline which suffers from a severe export-sector bias. The public sector, and the state, is either ignored or, to the extent that it is studied, it is merely looked at to show what types of institutional mechanisms have the export-sector wage setters devised to successfully dominate the rent-seeking actors in the sheltered sector. All the public sector actors can do in this world is merely to be undisciplined and extract rents. Seen from this perspective, CPE does not seem to differ much in scope from the public choice school in economics.

### 3.5 TESTING THE RIVAL HYPOTHESIS: DOES EXPORT-LED PATTERN BARGAINING EXPLAIN WAGE RESTRAINT IN THE GERMAN PUBLIC SECTOR<sup>18</sup>?

The explanation advanced in the literature to *directly* account for the pattern of wage restraint in the German public sector consists of the pattern bargaining hypothesis. According to this argument, unions in the export industries – usually the metalworking sector or the chemical sector – act as the first negotiators in the yearly bargaining season. Their wage settlements take concerns for export competitiveness into consideration. Wage requests are usually set so as to equal the increase in the labour productivity of the total economy plus projected inflation (Johnston and Hancke 2009, 617). Once this competitiveness-oriented wage norm has been established at the beginning of the yearly negotiating round, the pattern is then transferred to the other bargaining units in the German economy, ensuring across-the-board wage restraint. Public sector wage setters “shadow” the wage increases in the export industry and this

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<sup>18</sup> This section draws extensively from a paper of mine which I have published elsewhere. See Di Carlo (2018a).

prevents wage setting in the public sector from overshooting. A pattern of wage restraint, modelled on the needs of entrepreneurs and workers in the export sector, allegedly comes to be transferred *exogenously* into the wage-setting of public employees.

To test the validity of the pattern bargaining hypothesis, I perform a battery of basic hoop tests. In the social sciences, hoop tests belong to the realm of testing theories through observation and case studies. The investigator infers predictions from a theory. She then observes the data and asks whether observations are congruent with predictions (Van Evera 1997). Hoop tests are particularly suited to verifying the validity of theories, given that they consist of predictions of necessary conditions with high certitude: if the predictions fail the test of empirical evidence, the theory should be rejected (Bennett 2010; Mahoney 2012). I construct the battery of tests in such a way that each test taken alone is meant to be necessary but not sufficient to reject the thesis. Instead, all the tests taken together should give us the high degree of confidence sufficient to reject it. I proceed by making explicit and clearly formulated predictions which I then test against pertinent empirical evidence.

*Prediction 1: If, as prescribed by the export-sector-driven pattern bargaining explanation, the contracts of the export industries act as the pilot agreement (the pacesetter), we should expect to see that, during yearly negotiations, the metalworking or the chemical wage contracts are signed before the public sector contract, which they are supposed to influence.*

To perform the most adequate observation for Prediction 1, I have collected the dates of the signatures of the wage agreements in three key sectors of the German economy: the public sector (*öffentlicher Dienst*), the metalworking industry (*Metallindustrie*), and the chemical industry (*chemische Industrie*). Unions in these sectors are the actors who have the capacity to be independent wage bargainers (Streeck 1994, 125) in the German industrial relations system. Also, taken together, these three sectors constitute the core of the export industry and of the sheltered services. The period analysed is 1991–2016. Data comes from the *WSI's Tarifarchiv* and is organised in the table shown in appendix (B) at the end of the dissertation. During the period 1991–2016, for 11 years out of 26 the public sector contract is, in fact, the first negotiated contract in the wage bargaining season. When taking into account years in which contracts were not negotiated because of the longer duration of previous agreements, the net years in which other contracts have preceded and possibly influenced the public sector contracts are three for the chemical contracts and six for the metalworking contracts. These are slightly too few instances out of the 26 years analysed to maintain that pattern bargaining is at work. As a result, this observation seems to be incongruent with the prediction from the pattern bargaining hypothesis.

*Prediction 2: If pattern bargaining were present in Germany and followed the logic of similar percentage increases, we should expect to find the concatenation of the wage agreements in the export and public sectors.*

I operationalise such a test by expecting co-variation in the percentage change in export and public sector wage-setting. What can be observed is that the co-variation of wages in the manufacturing and public sectors – in terms of similar percentage increases – has weakened decisively in Germany. Interestingly, over the long run (1971–2007) the correlation holds ( $r^2 = 0.85$ ). The colour gradation of the dots in figure 6 (shading from darker to lighter grey) also indicates the gradual shift over time from a regime of high wage increases (1970s and 1980s) to a regime of very modest ones through the 1990s and early 2000s (bottom left side in panel a). A careful look at the decade 1997–2007, shown in panel b, indicates the collapse of pattern bargaining in Germany (from  $r^2 = 0.85$  to  $r^2 = 0.18$ ). In fact, the correlation breaks apart from 1996 onwards. The observation appears incongruent with the prediction of the theory. Furthermore, since pattern bargaining unravels right before the start of the EMU, and correlations are extremely weak during the first decade of the EMU, I arrive at the conclusion that pattern bargaining, as a specific type of inter-sectoral wage coordination observable through similar patterns of wage increases in manufacturing and the public services, was not present. Hence, it cannot possibly account for wage restraint in the German public sector during the first decade of the EMU.

Figure 6: Correlation between wage increases (% change) in manufacturing and public services in Germany (1971-2007)



Source: Author's elaboration from EU KLEMS Growth and Productivity Accounts, September 2017 release.

*Prediction 3: If pattern bargaining were to tame inflationary pressures from the public sector, we would expect to observe, over a two-decade time horizon, that the trajectory of wage increases in the public sector tends to outstrip – or at least closely follow – that of the manufacturing sector. This damaging dynamic is exactly what the pattern bargaining type of inter-sectoral wage-setting institution is allegedly supposed to repress.*

To make the observation on this prediction, I construct indexes of the trajectories of wage increases in manufacturing, the chemical sector and public services. I plot them against a so-called pattern bargaining benchmark. I also add the trajectory of wage growth in the total economy. As explained in the literature, wage-setters in the export industry would opt for a wage request calculated on the basis of labour productivity in the total economy plus projected inflation. I construct the pattern bargaining benchmark through a composite index of labour productivity in the whole economy (from EU KLEMS data) and the consumer price index (from World Bank data).

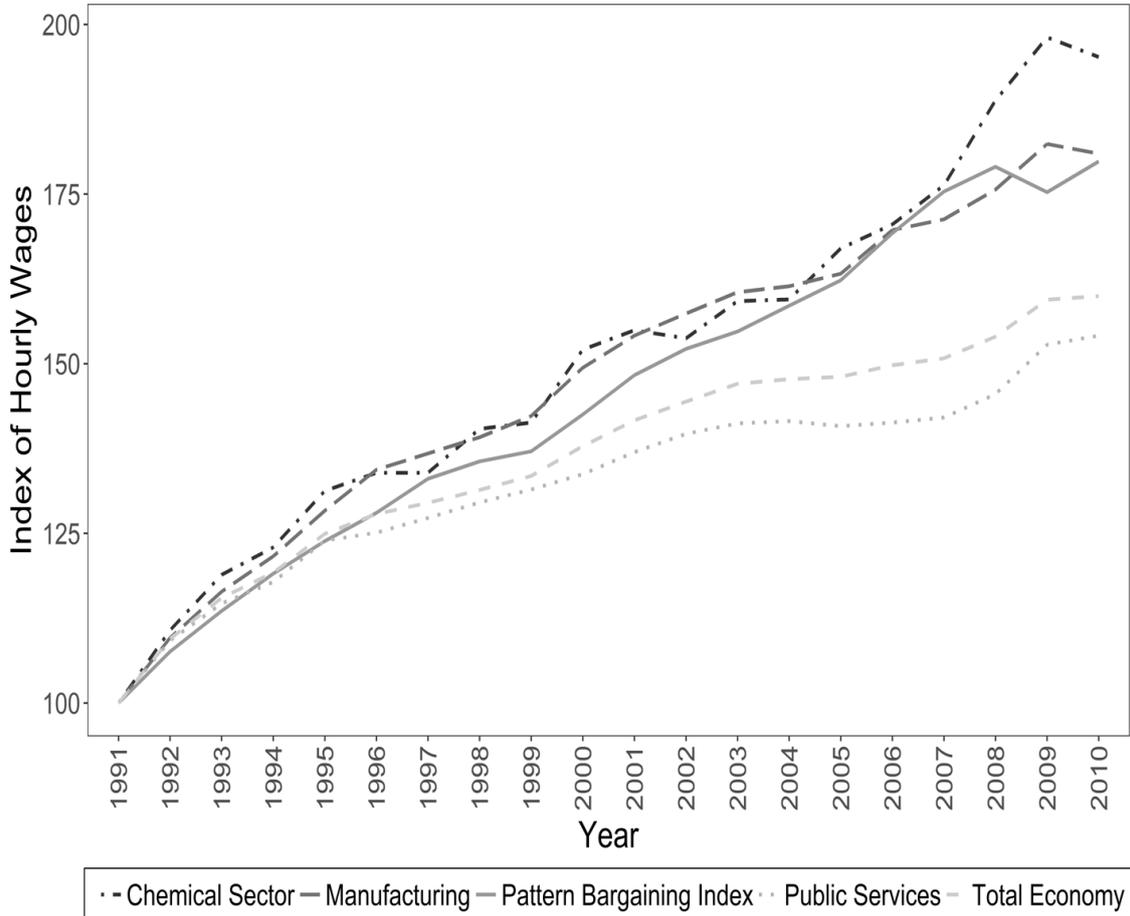
Figure 7 shows the growing dualization of the German economy taking place since the mid-1990s. On the one hand, wage increases in the chemical and manufacturing sectors have kept up with the long-term trend of average productivity and inflation. On the other, the trajectory of wage growth in the German public sector starts to diverge downwards since approximately 1994/1995. By the mid-2000s the trajectory of public sector wage growth has significantly fallen behind that of average wages in the economy. Indeed, if originally pattern bargaining in Germany worked to redistribute productivity gains from the most productive industries in the economy to the least productive ones (Streeck 1994), this seems not to be the case anymore after reunification. Wage increases in manufacturing and the chemical sector have consistently outstripped those across the whole economy. Industrial wages, it seems, were not so much anchored to average productivity in the economy but, most likely, benchmarked to their own higher industrial productivity gains. Growth in public sector wages, on the other hand, is severely penalised – even more than the average wage growth in the total economy.

There is, in other words, a marked and steady compression in the growth of public sector wages. Over the period 1991-2010 workers in public services have been barely compensated for the change in the cost of living (figure 8) and increasing disparities have emerged among the different sectors of the German economy. This is in line with the findings of the dualization literature reviewed above. To that, this exercise has added the observation that the increasing dualization process has affected also the German public sector and not only the low-end services.

In all, it can be concluded that the pattern bargaining hypothesis cannot account for wage restraint in the German public sector. Since the mid-1990s a decoupling of wage setting between manufacturing and the public sector has occurred. The marked divergence between the two sectors can certainly not be attributed to the exuberance of undisciplined public sector wage setters – which a pattern bargaining type of inter-sectoral wage coordination is supposed to repress. Rather to the contrary, public sector

wages have been subjected to a substantial downward adjustment. Data signals that this adjustment starts in the mid-1990s and is prolonged throughout the 2000s. In the 2000s the index of public sector wage growth flattens out.

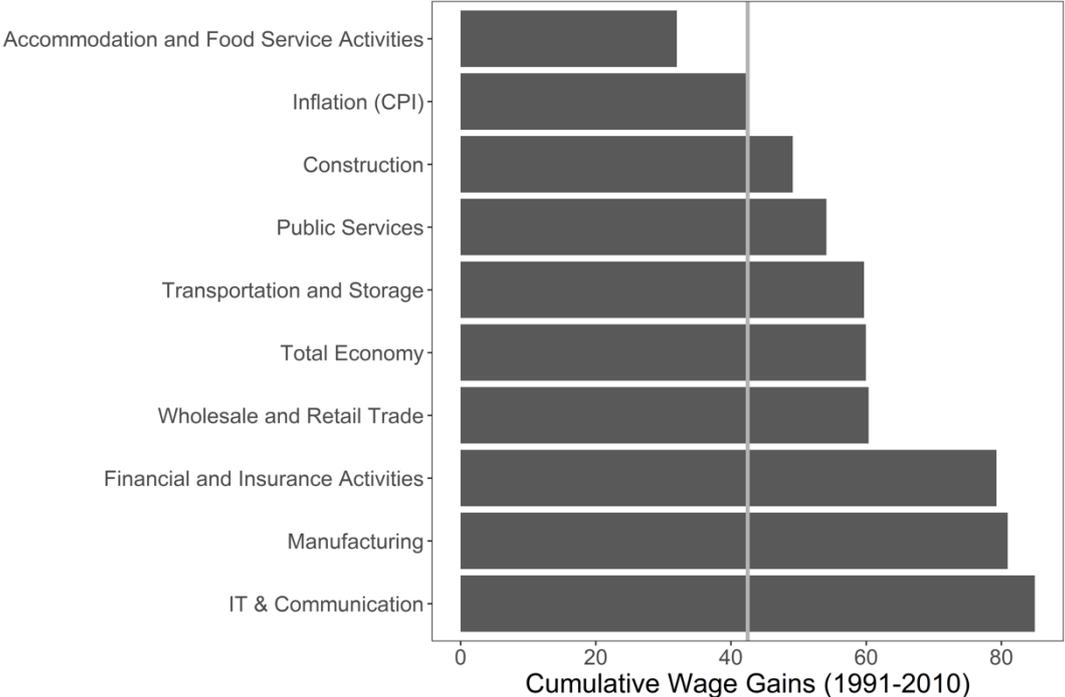
Figure 7: Indexes (1991=100) of nominal hourly wages in Germany in the export industries, the total economy, and the public sector, vis-à-vis the pattern bargaining index (1991-2010)



Source: Author's elaboration from EU KLEMS Growth and Productivity Accounts, September 2017 release.

These observations suggest that there must have been other factors which the pattern bargaining theory has missed and which have contributed to produce this pattern of restraint. Indeed, when getting familiar with the economic history of post-reunification Germany, one cannot avoid hypothesizing that the observed pattern is more likely to resemble a real fiscal adjustment rather than a process of inter-sectoral wage coordination. On the basis of the performed hoop tests I reach the final judgement that the pattern bargaining theory cannot be deemed valid to explain wage restraint in the German public sector during the period at stake. I thus move toward the search for an alternative explanation.

Figure 8: Cumulative wage gains\* of workers in selected macro-sectors of the German economy vis-à-vis price inflation (1991-2010)



Source: Author's elaboration from EU KLEMS Growth and Productivity Accounts, September 2017 release.

\*Gains expressed as cumulative percentage wage increases as of 2010 vis-à-vis 1991.

## **CHAPTER 4. Toward a state-centred institutionalist framework for the study of public sector wage setting**

This chapter is theoretical nature. Its function is to introduce a state-centred institutionalist approach to the study of public sector wage setting. It builds on actor-centred institutionalism in political science. In sub-section 4.1 I present the key features of this theoretical approach and discuss why it is to be preferred to a comparative historical analysis (CHA) approach. In sub-section 4.2 and 4.3 I introduce the key policy actors engaged in the adoption of public sector wage policy and discuss their peculiarities vis-à-vis their private sector counterparts. I discuss first the nature and role of the public employers as “sovereign” state actors in their function of public sector wage setters. Subsequently, I deal with the labour side to understand the peculiarities of public sector’s trade unionism and their “political” power resources. Sub-section 4.4 introduces a “static” analytical framework for the study of public sector wage setting which theorises the state as an institutional contextualisation within which these actors adopt wage policy. Lastly, sub-section 4.5 offers a more “dynamic” understanding of public sector wage setting by linking actors and structure to the politics of fiscal policy. Drawing on Gourevitch (1986, 54), it argues that “(T)o explain economic policy choices, we need to link policy outcomes to politics.”

### *4.1 FOUNDATIONS OF THEORY-GUIDED PROCESS TRACING: STATE-CENTRED INSTITUTIONALISM AS AN ALTERNATIVE THEORETICAL APPROACH*

Institutional approaches in comparative policy research may be divided into *problem oriented* and *interaction oriented* (Scharpf 1997b). Problem oriented research focuses on the analysis of societal problems which policy measures must resolve. Policy research of this kind analyses the nature and causes of problems and attempts to assess the potential effectiveness/appropriateness of given policy solutions. Interaction oriented policy research, instead, concentrates on “the interactions between policy makers” and the “conditions that favor or impede their ability to adopt and implement those policy responses that problem-oriented analyses have identified as being potentially effective” (Scharpf 2000, 763). This dissertation falls within the realm of interaction oriented policy research in CPE.

The analytical framework developed here builds on the precepts of actor-centred institutionalism. This approach moves from the assumption that policies are to be explained as the outcome of interactions among intentional actors. Policies and actors’ interactions are structured by the characteristics of the institutional setting in which they take place (Mayntz and Scharpf 1995; Scharpf 1997b). Differently from Scharpf (1997b), the dissertation does not follow a game theoretical approach. I take a more

historical approach in line with Gourevitch (1986) and his ambition to uncover systematically the political/historical processes through which actors translate their material preferences into policy through power. With Gourevitch (1986) I share the interest in studying how actors mobilise resources and form political alliances to achieve preferred policy outcomes. With Scharpf (1997b) I share the concern to avoid merely descriptive historical reconstructions and the necessity to specify an analytical framework capable of generating systematic knowledge beyond the unique circumstances at hand. Like Gourevitch (1986, 17), I start from the assumption that if a governmental policy is to prevail, “it must obtain support from those who have political power.” Thus, the dissertation lies in between the interests-based and the institutions-based approaches in CPE presented in the literature review.

Actor-centred institutionalism shares various similarities and some differences with the comparative-historical approach (CHA) favoured by other scholars in CPE and comparative politics (Mahoney and Thelen 2015; Thelen, Longstreth, and Steinmo 1992). Both tackle “real world puzzles” and aim to produce pragmatic knowledge with real world implications. Both share scepticism vis-à-vis the quest for general laws in the social sciences and privilege case-based research explaining outcomes which are particular in time and space. CHA scholars have made temporal explanations their forte. Taking seriously the “temporal structure” of their “temporally oriented” explanations is a distinctive feature of this research agenda (Mahoney and Thelen 2015, part III; Pierson 2004). While putting less emphasis on time, Scharpf (1997b, 5-10) does not ignore the phenomena’s temporal dimension. Temporal structures are theorised in the form of sequential non-cooperative games whereby after a first mover, other actors make choices in the knowledge of other actors’ previous choices. Both approaches share an interest for macro-configurational research in that they analyse aggregate cases (e.g. nation States, social movements) and complex organisational and institutional arrangements. CHA takes a configurational approach. It explains macro outcomes “by examining how variables work together in combinations or causal packages” under the assumption that “there is no alternative to analysing the effects of causes in light of the context in which they occur” (Mahoney and Thelen 2015, 7-8). The configurational approach is shared by actor-centred institutionalists where great care is paid to theorizing the characteristics of actors’ constellations and modes of interaction which structure the process of policy adoption.

CHA’s explanations rely prominently on specifying the causal mechanisms “through which causes and causal configurations exert effects within particular cases” (Mahoney and Thelen 2015, 15). This has worked hand in gloves with the use of a process tracing methodology in which the researcher traces systematically the intervening steps through which an initial cause leads to a final outcome (P.A. Hall 2013; Mahoney 2012). While Scharpf (1997b) relies on a game theoretical approach, his famous study on the economic policies implemented by social democratic governments during the 1970/80s demonstrates that actor-centred institutionalism can be combined successfully

with the use of causal-process observations and a more historical approach to case studies (Scharpf 1991).

What in my understanding distinguishes the two approaches is the way in which they conceive of the relationship between agency and structure – although this separation may be less accentuated in practice than it seems in theory. CHA gives explanatory predominance to contextual structural features. According to these scholars, the validity of macro-level arguments “does not require that they be broken down into individual-level behaviours” (Mahoney and Thelen 2015, 6). Case studies revolve around aggregate cases at the macro and meso-level where structural features of the context not only shape the outcomes but also the strategies of individual agents. Actors are not seen as all-knowing rational self-oriented maximizers but more as ecologically rational *rule-following satisfiers*. Historical empirical analysis then tells us what are actors trying to maximise and why they emphasize certain goals over others (Steinmo and Thelen 1992, 9). Actor-centred institutionalism, as the name suggests, brings actors to the fore. Yet actor-centred analysis does *not* preach methodological individualism. Quite to the contrary, it maintains that:

*“public policy is not usually produced by a unitary actor with adequate control over all required action resources and a single-minded concern for the public interest. Rather it is likely to result from the strategic interaction among several or many policy actors, each with its own understanding of the nature of the problem and the feasibility of particular solutions, each with its own individual and institutional self-interest and its own normative preference, and each with its own capabilities or action resources that may be employed to affect the outcome” (Scharpf 1997b, 11).*

Actors are not understood as omniscient and fully informed. They form preferences through a combination of basic self-interest, normative orientations and identity-based factors. Given their understanding of policy as being the result of intentional action, actor-centred institutionalists urge researchers to focus on the actors controlling the use of policy instruments. However, actors do not act in a vacuum. Policy actors interact with other key actors engaged in the policy process and have to mobilise “action resources” that enable them to influence the outcome “in certain respects and to a certain degree” (Scharpf 1997b, 43). Actor-centred institutionalism requires a thorough analysis of the capacity of policy systems to enable/constrain the adoption of policy choices. As such, scholars point to the fact that actors’ action resources and the overall institutional capacity vary according to the type of policy problem at hand and the policies actors strive to adopt. Actor-centred institutionalism thus explains policies via actors’ intentional mobilisation of resources for controlling policy instruments, in interaction with competing actors and within policy systems. CHA emphasizes more the structural side of the process. Actor-centred institutionalists treat institutional conditions only as remote causes and actors’ interacting choices as proximate causes (Scharpf 2000, 764).

In preferring actor-centred institutionalism over CHA I do not wish to suggest that the one is better than the other. CHA is a promising theoretical approach for the study of macrosocial phenomena. However, the objective of the dissertation is to explain the adoption of specific policies in the realm of public sector wage setting, for which a purely macro-perspective has little to offer. Actor-centred institutionalism, with its policy orientation, seems better equipped for the purpose. Given its focus on actor's interactions, it is especially useful to analyse how the dividedness among policy actors is overcome in the implementation of public sector wage policy.

The type of approach I develop here could be thought of as state-centred. This means that, in the analytical framework, I theorise on the state as the arena within which wage setting in the public sector takes place. To explain public sector wage policy, I emphasize the strategic choices and the interactions of actors *within* the contours of the state and study how the public employers interact among each other and with policy actors *across* civil society (i.e. the trade unions). In aiming to explain public sector wage policy from the perspective of state actors, I am most interested in shedding light on the conflicts of interest which occur among various types of public employers and the trade unions within the institutional architecture of the state.

One may surely criticise the choice of giving greater emphasis to the public-employers' side. The straightforward criticism to be made, I acknowledge, is that it risks leaving the labour side somehow in the background. In making this choice, by no means I wish to suggest that trade unions do not matter. They do. Other sub-sections will try to pay justice to their peculiarities and during the case study I will analyse when and how trade unions and their resources come into play. The choice to focus most prominently on the role of the public employers in the determination of public sector wage setting is motivated by the central asymmetry of power which characterises public sector industrial relations, namely the public employers' *sovereign authority*. The "unassailable right" of the state to act unilaterally creates a fundamental asymmetry in wage bargaining. In theory, state sovereignty means that the public employers have the legal capacity to implement legislation to override unions' opposition. This is an action resource which is absent in the private sector and whose use in the public sector has been often mentioned by academic works but rarely studied in practice.

Furthermore, research has been showing the decline of European trade unions (Visser 1994) and their incapacity to hold out against the employers' liberalizing offensive in the realm of private sector industrial relations (Baccaro and Howell 2011; 2017). Unions have been almost everywhere on the defensive. Private employers' discretion has been long on the rise. But what do we know about the public employers? After all, the state remains the single biggest employers in every advanced economy (Hyman 2008). Since the 1980s, all over Europe governments have been very active and directly engaged in reforming the state's collective bargaining machinery to shrink public sector labour costs. They have done so by restraining pay and benefits and by curtailing employment in concomitance with processes of state restructuring and public

management reforms (Ferner 1995). Rolling back the state in the provision of essential services to cut public expenditures has been a major preoccupation of virtually all governments since the 1980s in the face of fiscal and economic crises (Ferner 1994; Oxley et al. 1991). Yet, with the only exception of public sector employment relations scholars, the various strands of literature reviewed in this dissertation are silent about the role of public employers as state actors.

Thus, giving the “state” centre stage seems to me justified by the necessity to right these gaps in the literature and bring the public sector *proper* within the radar of CPE scholars. Public sector employment relations studies do consider the structure of the state in their works. However, these scholars generally study descriptively how personnel is employed within the public administration and how wage setting takes place within the boundaries of the legal system. Influenced by a Weberian understanding of the state, they understand it merely in terms of its *modus operandi* (Hay and Lister 2006), which is to say mostly from an organisational point of view. The state is studied only as the administrative employer instead of the governing authority of the polity in the exercise of its functions. Furthermore, the whole fiscal edifice through which the “continuous operations” of the administrative organisation are made possible is often ignored. The public administration – as well as the salaries of the staff employed therein – is funded through taxation. This means that the money governments spend to fund personnel policies ultimately has to be earmarked in budget laws. This is a crucial aspect to which these scholars have paid scant attention. While rightly following Weber in the organisational understanding of the state, these scholars have forgotten a nuance in Weber’s work: the *Steuerstaat* (the tax state). Weber was well aware of the necessity for the state to acquire the financial resources needed to ensure the continuous operations of the administrative machinery through taxation (Weber 1978, 351-53). Public sector employment relations scholars have instead neglected that public sector wage policy is shaped by the fiscal structure of the state as well as the political conflicts revolving around the budget process.

In this respect, CPE does comparatively worse. Here the state is surprisingly absent. The “Varieties of Capitalism” perspective influentially advanced by P. Hall and Soskice (2001) and the more recent turn toward “Growth Models” popularised by Baccaro and Pontusson (2016) are prominent examples. Both assume that competitive pressures facing large firms in the country’s dominant economic sector constitute the major factors shaping the institutional setting of the political economy as well as the choice of production strategies/growth models pursued. Due to the dominance of firm-centred and export-sector-centred perspectives, political economists have often negated an independent role for the state, both in the polity and in industrial relations. The public sector and its political dimension have been ignored. Arguably, both the Varieties of Capitalism tradition and the Growth Models approach leave the state in the background and assume it as a mere perpetrator of the interests of dominant productive classes. In the VoC tradition, it is the interests of firms in the economy that dominates

the scene. In the new Growth Models perspective, it is the interests of dominant social blocs in key economic sectors that guide overall economic policy.

This understanding of the state (or worse its neglect) falls prey to the statist's critique. In an attempt to "bring the state back in", in the 1980s, political scientists emphasized the importance of the state as both an actor and a set of institutions (P. Evans, Rueschemeyer, and Skocpol 1985). Skocpol (1979) has rejected the Marxist assumption that state actors cannot act in contrast to the material interests of the dominant class. On the contrary, she has prominently assigned an autonomous role to the state, implying a demarcation between the state – as a self-standing actor and structure in the polity – and societal/producer groups. Most importantly, Skocpol recognised that the basis of state power lies within its administrative and coercive organisations; that the state has its own distinct interests vis-à-vis the dominant social groups; and that state organisations have independent agency which is potentially autonomous from direct dominant class control (M. Evans 2006, 47-48).

Thus, with the framework developed, I aim to shed light on the importance of public employers as state actors in the determination of public sector wage policy. This dissertation embraces fully the statist's critique according to which the state cannot be reduced to the status of a puppet at the mercy of producer's groups in dominant economic sectors of the economy. This is especially so because the state is composed of a set of heterogeneous actors and institutions. The set of heterogeneous actors which operate within the state are not neutral and indifferent to the determination of wage policy. So the state is not a monolithic bloc capable of frictionless unitary action. To the contrary, I contend that what characterises the state is rather its *internal dividedness*. The fragmented nature of today's States creates scope for administrative and political conflicts of interest within the public employers' camp (Ferner 1988). While entering wage setting interactions with the labour counterpart, the public employers have to manage simultaneous coordination problems among the plethora of state actors involved in the process of fiscal and wage policy. How intra-state conflicts of interest are resolved depends on who these state actors are and how they interact within the institutional setting which shapes - *without fully determining* - strategic choices by providing incentives and constraints to the wage setters.

In sum, it can be said that by putting explanatory emphasis on how the structure of the state, its rules and institutions exert substantial causal effect on policy outcomes, this dissertation advances what is generally understood in the literature as a "*state structure explanation*" (Gourevitch 1986, 61). The explanation I advance through this state-centred approach runs in opposition to the "economic ideology explanation" based on Germany's obsession with *Ordoliberalismus* (see sub-section 3.1); to the "production profile explanation" based on the supremacy of the economic interests of Germany's export sector elites (sub-section 3.2); and to the "institutionalist explanation" based on the effect of institutions for the coordination of wage bargaining across the economy (section 3.4 and 3.5).

In the following two sub-sections I now introduce the two sets of policy actors which take part in processes of public sector wage setting. I begin by discussing the nature and role of public employers as state actors to then move to public sector trade unions.

#### 4.2 TOGETHER WE RULE, DIVIDED WE STAND: PUBLIC EMPLOYERS AS SEMISOVEREIGN STATE ACTORS

The industrial relations literature has acknowledged “the role of the state” as a public employer intervening directly in industrial relations. But what and who is the state? And how do public employers stand in relation to the state? In the industrial relations literature and in political science debates we read that the state is the sovereign authority in the polity. For public sector wage setting this means that the state is the sovereign employer. It is lawfully capable of overriding labour’s resistance through legislation upheld by the legitimate use of coercion in the polity. In political science parlance, the state’s hierarchical authority creates a capacity for “hierarchical direction”, i.e. “a capacity to override the preferences of other actors” on the basis of the “superior capacity to offer rewards or to threaten severe deprivation” which may also “rest on legitimate hierarchical authority” (Scharpf 1997b, 172). This capacity depends on the fact that the state is the employer in the public administration but it is concomitantly the sovereign authority which defines and manipulates the rules of the game in the polity (Traxler 1999). In other words, the state in public sector employment relations is simultaneously what Streeck and Thelen (2005) would call a *rule taker* and a *rule maker*.

If, following Weber, we understand power (*Macht*) as the “probability that one actor within a social relationship will be in a position to carry out his own will despite resistance” (Swedberg and Agevall 2005, 205) and if the public employers are sovereigns, then it must follow that, in case of conflicts, the probability that the public employers will carry out their own will against labour’s resistance is one, i.e. certainty. But this reasoning only holds true if public employers’ sovereignty were absolute. It appears to me that much of the literature – inspired by a Hobbesian vision – treats state sovereignty as being “unified” and “unconditional” (Baumgold 2017). While in legal terms it is certainly true that the state is the sovereign authority, in the practice of public sector wage setting, sovereign power (i.e. hierarchical direction) can instead be deployed only under some circumstances and not in others. This shall mean that the “probability to carry out the public employers’ will despite resistance” is not fixed but varies according to heterogeneous institutional, political and environmental conditions. This may be because of the following reasons.

Firstly, public employers as state actors in modern democracies also operate within a variety of institutional arrangements (checks and balances) which limit the state’s hierarchical authority (Scharpf 1997b, Ch. 8). Thus, public employers are not “free spirits” capable of easily shaping the political reality according to their volition.

Institutional mechanisms exist within the contours of the state which establish the “rule of law” to which public employers are bound. Most prominently, through the presence of an independent judiciary in modern States, the sovereign power of the public employers is kept within the principle of legality.

Secondly, public employers are actors *within* the state, *they are not the state*. In other words, public employers are just a sub-set of actors within the state institutional setting which includes a multitude of other institutional actors (themselves sub-sets) with their own organisational interests. Their policy prerogatives are most often shared with other centres of political authority within the polity with whom the public employers must coordinate to enact wage policies. This makes them “semisovereign” policy actors within the state’s institutional configuration. The constellation of actors within the state creates scope for “inter-role conflicts” (Beaumont 1992), especially because public sector wage policy requires coordination among actors within two policy spheres of the state: fiscal policy and public sector wage policy. To be able to deploy sovereign authority public employers must first come to terms with their internal dividedness.

#### 4.2.1 THE DIVIDEDNESS OF PUBLIC EMPLOYERS WITHIN THE STATE

The very conceptualisation of the state and its sovereignty, Hay and Lister (2006) remind us, has undergone several transformations over the last centuries. In its pre-modern formulation, state and sovereignty were synonymous and the sovereignty of the state resided in the body of the ruler. With Machiavelli, the state became synonymous not only with the prince himself, but also with the wider political regime, the geographical territory over which the state claimed and maintained sovereign authority and with the set of institutions of government necessary to enforce such authority. It was with the rise of the absolutist state in Europe and the writings of Hobbes and Bodin that in its modern conceptualisation the state came to be seen as a distinct form of authority independent of those individuals who act in the execution of its powers. In the modern formulation of the state, influenced by Hobbes’ thought, individuals are subjects of the state to which they owe their allegiance. The authority of the state is singular and absolute and the state is the highest form of authority in all matters of civil government (Skinner 1989, 90).

This Hobbesian formulation continues to yield a great influence on contemporary state theory, itself the result of the works of Max Weber. The *Staat*, Weber argued, is “a compulsory political organisation with continuous operations” whose “administrative staff successfully upholds the claim to the monopoly of the legitimate use of physical force in the enforcement of its order” (Swedberg and Agevall 2005, 265). From the modern Weberian definition, thus, three aspects of the state need to be discussed in the context of public sector industrial relations: the state’s organisational characteristics (the political organisation in Weber’s definition), its functions (the continuous operations) and its sovereign authority.

From an organisational perspective, the state should be thought of as an “institutional contextualisation” (Hay and Lister 2006) within which political actors are embedded in the execution of their governing functions. The state thus consists of the set of institutions whose continuous operations ensure the functioning of the polity. The state forms the institutional, legal, procedural and authoritative landscape within which actors interact. The state is therefore a “strategically selective” contextualisation in that its structured institutional setting presents actors with opportunities and constraints which shape their strategies and preferences (Jessop 1990). Political actors act within the contours of the state while never fully coinciding with its totality. State actors are in every moment bits of the state’s institutional contextualisation. Within this institutional setting they execute functions. As a result, those state actors in charge of wage determination for the public personnel execute but one function among the  $n$  other continuous operations of the state. However, nothing ensures us that, within the institutional contextualisation of the state, the “state as an employer” is a unitary actor who has the means and the will to pursue a given wage policy.

When industrial relations theory speaks of the role of the state as a public employer, it is (erroneously in my view) conflating the state as an institutional contextualisation with the public employers’ wage setting function. Hyman (2013, 109) famously explains to us that “the simple notion of ‘three actors’ in industrial relations – workers, employers and government – is inadequate, since the state so to speak occupies two seats at the table. Thus, what the literature must mean instead is that, within the contours of the state’s institutional setting, those state actors who execute the wage setting function for the public personnel also govern the polity. However, the fact that in modern States political authority is dispersed suggests that, if there is no single government within the state, there can hardly be one single public employer. Where this is the case, nothing ensures us that the interests and strategies of different governments and therefore of different public employers will be aligned and conducive to unitary state action in public sector industrial relations. The dispersion of political authority within the politico-administrative system of the state occurs along two basic dimensions (Pollitt and Bouckaert 2017, 48-53).

*Vertical* dispersion of authority refers to the degree of political authority shared between different levels of government within the state. Thus, with highly centralised States most of the significant political decisions are taken within the central government while in States with federal constitutions political authority tends to be dispersed in favour of lower levels of government (regional, local). Similarly, also unitary States with no constitutionally guaranteed division of power may *de facto* be extensively decentralised when key powers are statutorily delegated to local governments. Where vertical dispersion of authority exists (and if each level of government has the legal competence to act as the wage setter for its own staff) then unitary state action in public sector wage setting is undermined by *problems of vertical coordination* among different levels of government. Thus, policy capacity in public

sector wage setting depends not only on the legal competence to set wages – which is the results of other employment regulations – but also on the structure of polity.

*Horizontal* dispersion of authority pertains to the political power shared among different institutional actors (e.g. ministries, agencies, etc.) within one level of government. Within the context of horizontal dispersion of authority, unitary state action is undermined by *problems of horizontal coordination*, i.e. the capacity of executives to ensure that all actors “pull in the same direction”. Given the heterogeneous types of continuous operations which different institutions carry out within the state, their institutionalised responsibilities and their financial endowments, nothing ensures us that different ministries in public sector wage setting will “pull in the same direction”. We should rather expect different administrative agencies to be in conflict within the state contextualisation (Ferner 1988). Regarding public sector wage policy, this is extremely likely given that the execution of wage policy coincides simultaneously with fiscal policy. Most prominently, in public sector wage setting we should expect a crucial tension between finance ministries and auditing agencies whose institutional role is that of controlling governments’ expenditures vis-à-vis the interest of politicians or other ministries. It is in fact recognised that crucial conflicts of interests may emerge between the treasury, in charge of ensuring the soundness of public finances, and political actors who may be tempted exploit the public purse for private political gains (Dell’Aringa 2007).

A third source of public employers’ dividedness stems from the nature of the executive government. This creates problems of *intra-governmental coordination* between different parties. The nature of the executive government refers to structural characteristics of the government and the set of conventions and habits which shape the governing mode of given executives. These range from less adversarial, consultative and consensus-based to more adversarial and majoritarian-like (Pollitt and Bouckaert 2017, 53). Since public sector wage policy is fiscal policy, the structure of the executive government shapes the politics of fiscal policy and therefore the capacity of the policy system to adopt public sector wage policy. The more majoritarian decision-making is, the higher the capacity of the party in government is to set legislation and implement a desired course of action in wage policy. The more consultative and consensual the nature of the government becomes, the more likely it becomes that public employers will be, in fact, divided. Where this is the case, partisan veto players (Tsebelis 1995) may block governmental action or require modifications to/compensation for a given course of action in fiscal/wage policy.

What complicates matters further is the heterogeneity of purposes for which political actors act. While (simplifying) private employers undertake the entrepreneurial risk for the sake of the profit-making motive, governments are concurrently bound to administrative, political and economic considerations other than problems of wage determination. Governments bear responsibilities not only to the staff they employ in

the public administration. In democratic systems, they are confronted with the wider citizenry which funds the state machinery, makes use of the public services which the state provides and ultimately chooses the political identity of the public paymaster through elections (Bryson and Forth 2008, 504). The complexity of studying the role of the government in public sector employment relations stems from the fact that, at any time, governments may be weighting different concerns of administrative, political and economic nature. These considerations to which the public employers are bound may interfere and affect processes and outcomes of public sector wage setting.

As administrative managers, in fact, public employers execute management functions within the context of the organisations for which they are legally responsible. As such, they are bound by constitutions to guarantee the ongoing provision of public services to the community by ensuring the efficient functioning of the public administration under their responsibility. Within this context they are directly responsible vis-à-vis the staff they employ. As the political authority, however, public employers have also a wider responsibility vis-à-vis the citizens-customers to act according to the principle of *buon governo* (good governance). They must guarantee a thrifty yet adequate use of taxpayers' money for the provision of public services.

On the other hand, through the political parties of which they are expression, governments fulfil *representative* and *governing* functions in the polity (Mair 2009). They aggregate and represent citizens' interests to the state (government by the people) and perform governance functions, implementing policy that would serve the interest of their supporters and possibly the common interest of the polity (government for the people). Given the symbiotic interdependence between the democratic state and the capitalist organisation of today's economic systems, to secure their survival in office, governments have to strike a delicate balance between the need for political representativeness in democracy and responsible and efficient economic policy making in capitalist systems (Scharpf 1999). This induces governments not only to act prudently and responsibly in conformity with external constraints and legacies (Mair 2009, 10-13) but also to intervene in the economy through macroeconomic policy to mitigate the impact of markets on voters' lives.

Public employers therefore are at any time a political and economic entity. Actors of the state hold various responsibilities beyond the industrial relations system (Beaumont 1992, 15-19). They always act in a political environment but bear responsibility for the efficiency of the economic system as a whole, not only the state machinery. When acting public employers may be simultaneously subjected to different types of calculi. These may or may not be coherent among themselves and with the interests of other social groups in the country.

#### 4.2.2 THE REGULATION OF THE ROLE OF STATE IN PUBLIC SECTOR WAGE SETTING

States' involvement in public sector wage setting occurs through the group of people having management responsibility for personnel in the public administration. As I have argued, it is not a given that the functions of administrative employer and governor of the polity must coincide within one single organisational entity.

Different legal arrangements exist that regulate employment and industrial relations in the public sector. Understanding their characteristics is crucial to comprehend how the sovereign authority of the state is confined within the legal structure of the state and how it interacts with its counterparts in matters of wage setting. Different dimensions of public sector employment relations need to be considered (Beaumont 1992; Bordogna 2007; Ozaki 1987; Traxler 1999), namely the *mode of employment regulation*, the *level of regulation* and the *characteristics of public employers' representation*.

In general terms, three forms of state regulation have been recognised (Jessop 1991) and applied to the study of industrial relations (Traxler 1999): *statism* whereby the state resorts to its authoritative exercise of power to impose binding provisions; *corporatism* whereby the state parts its "public-order function" with organised business and labour through *concertation* with social partners or by granting them *associational self-regulation* rights; *neoliberalism* whereby the state externalises onto the market mechanism the task of regulating the relationship between labour and business.

While in the private sector collective bargaining is generally the standard mode to regulate industrial relations, in the public sector the principle of joint regulation is affected by the sovereign authority of the state. The mode of employment regulation in the public administration thus depends on the degree to which the state is entitled to unilaterally dictate the terms of employment. The mode of employment regulation can be thought of as a continuum ranging from unilateral determination by the sovereign employer on the one extreme and full joint regulation through collective bargaining on the other. In the former type of regulation, the state unilaterally fixes the terms of employment (e.g. for the *Beamte* civil servants in the German system) even though, in practice, consultations and negotiations may occur informally with the unions. Unilateral determination of employment conditions generally comes with a special legal *status* attached to the requirement to act as a servant of the state and in respect of the public interest.

In the form of collective regulations, the public employers bargain with the trade unions to define the terms of public employment, although often some special groups performing key state functions (e.g. judges, armed force, police) may be exempted from collective bargaining rights and subjected to unilateral regulation. Various hybrid forms exist in between. Examples are government's unilateral regulation based on recommendations made by ad hoc commissions (e.g. in India and Malaysia);

government's determination on the basis of institutionalised comparability surveys, like in Japan where the National Personnel Authority issues recommendations on the basis of employment conditions in comparable jobs in the private and public sector; government's unilateral determination on the basis of institutionalised joint consultations with the unions (e.g. the Netherlands).

Mixed systems can exist in which some segments of the public administration's labour force are regulated via state's unilateral authority and others are subjected to joint regulation via collective bargaining with the unions. Germany is a notable example where the civil servants (*Beamte*) are subjected to the state's sovereign authority while the rest of the public employees are regulated via collective bargaining. Where joint regulation through collective bargaining exists between the public employers and the trade unions, institutions for conflict resolution acquire importance to the extent that resolutions to disputes can be legally enforced on both parts.

The level of regulation acquires enormous importance because it refers to the question as to *who* management in the public sector is. Public sectors of parliamentary democracies are characterised by the dispersion of competencies and management responsibilities which are determined by constitutional divisions (Beaumont 1992). As already mentioned, political authority can be divided horizontally between political and non-political (e.g. state agencies) centres of power and vertically between the central government and subnational authorities (e.g. regions or municipalities). The result of varying state structures is generally *a shared management authority* with responsibilities differing across the institutions of the state and regarding the subjects of regulation. It is thus key to discern who is in charge of determining employment conditions and whether regulations apply to all employee groups jointly or separately to different occupational or sectoral groups (Traxler 1999, 60-61). Responsibility for regulation of public employment and wage setting can thus lie with the central, regional, local or departmental level of the state apparatus. Responsibility for public employment can be shared across state levels and departments. Different groups of employees may be subjected to different authorities and different types of regulation.

Moreover, the authorities representing the state as an employer of labour are diverse across countries. Since public personnel's pay, like any other government's expenditure, must eventually be voted by parliaments, parliaments retain a special position in the process of pay determination (Ozaki 1987, 283). In some countries, this has given parliaments centre stage in the determination of public sector pay which is understood as a duty of the parliament. In others, however, parliaments have explicitly or implicitly delegated this responsibility to executive organs of the government. The form and extent of such delegation varies. In some countries it is the Ministry of Finance, as gate-keeper of the treasury, to oversee employers' representation in the public administration. In others (e.g. Italy or Sweden), specialised agencies have been created to represent public employers in matters of employment relations. Mixed patterns are also possible. In some countries the system of public employers'

representations entails the involvement of a wider range of ministries or departments, like in Germany where, in practice, the finance and Interior Ministers are both responsible for wage determination in the public administration. There may also be cases in which each employing authority is directly responsible for employment determination and interest representation vis-à-vis its own employees, or mixed patterns where some authorities act joint within institutionalised forms of cooperation while others act separately outside them.

#### *4.2.3 PUBLIC EMPLOYERS' SOVEREIGN AUTHORITY RECONSIDERED IN LIGHT OF THEIR DIVIDEDNESS AS STATE ACTORS*

This section on the public employers has taken off from the concept of States' unilateral power in public sector wage setting. Sovereign employers, it is usually argued, have the capacity to override the preferences of opponents by virtue of their hierarchical authority in the polity. However, I contend that, while in theory political sovereigns surely maintain their sovereign prerogatives, in practice the capacity of the state to deploy its sovereign authority in wage setting is contingent on two factors: the legal context and the capacity of public employers to overcome internal collective action problems.

As a necessary condition, the legal arrangements which regulate public sector employment and industrial relations must guarantee to public employers a legal competence to act unilaterally in wage bargaining. Otherwise, failing to act within the boundaries of the rule of law will cause the public employers to be challenged before an independent judiciary. Whether public employers have the legal capacity to determine wages unilaterally in the public sector depends on the mode of regulation of public sector employment relations.

Having the right to act unilaterally however is not sufficient for sovereign authority to be deployed. If public employers are internally divided, to successfully deploy sovereign authority as a unitary policy actor they must first overcome their intestine coordination problems and/or political conflicts. These emerge from the fragmented nature of the state. Public employers may be divided along three dimensions within the state contextualisation. They may be divided vertically among different public employers located at different levels of government. Secondly, public employers may be divided horizontally across different departments/ministries/agencies. This division may be augmented by conflicts of interest between institutional actors in charge of fiscal policy and those in charge of wage policy, if the competence for the execution of the two policies does not lie within the same institutional entity. Thirdly, even within governments, political parties may be divided on the merits of a given public sector wage/fiscal policy to be pursued.

The implication of this reasoning is that: while all sovereign employers are public employers, not all public employers can and wish to act as unilateral sovereigns. They can act as sovereign employers only when the two conditions hold, and they may wish to act unilaterally only when they deem it politically wise.

#### 4.3 PUBLIC EMPLOYEES AND THE POLITICAL DETERRENCE POWER

Organised labour constitutes the counterpart to public employers in the process of wage determination. While the previous sub-section has focused on the public employers as state actors, this section discusses the specificities of trade unionism and industrial action in the public sector. In general terms, industrial relations are profoundly affected by the nature of the markets in which firms compete (Brown 2008). Although the public sector does not produce goods and services which are for sale in markets - or perhaps exactly because of that - it is appropriate to begin from the peculiar nature of the services public employees provide. This has implications for what the “capital-labour nexus” means in public sector industrial relations. It has also relevance to understand the legal terms of an employment relationship with the state and the very distinctive nature of industrial conflict in the public sector. All these factors shape the type resources available to public sector unions to assert the interests of the workforce within the context of the state.

##### 4.3.1 THE NATURE OF THE SERVICES PROVIDED

Some distinctive features characterise the public labour and differentiate it from the private sector. Although fees may occasionally apply, most of public services are not for sale in markets and are instead financed via public budgets, themselves the result of tax receipts or borrowing. This means that, in the absence of a market exchange and a price mechanism, there are neither “traditional” producers nor customers – at least in the narrow sense one can think of in the context of the market sector.

As a result, from the employers’ side, the decision on the type and quantity of services to be produced is primarily a political decision. Public employers’ choices regarding production are inferred indirectly through “voter expressed demands for government services” rather than “through a marginal revenue product curve” (Fogel and Lewin 1974, 414). Citizens thus determine “through the ballot box” the quantity of public goods and services on the basis of their perceived needs (Gill-McLure 2007). Given the absence of a motive for profit maximisation in governments’ services provision, there cannot be a “capital-labour nexus” akin to the private sector. In fact, the act of availing oneself of the publicly provided community services constitutes a “non-market transaction” which produces *use-value* instead of *exchange-value* (Gill-McLure 2013). The essential services provided by the state cater to the public needs not to private demand. In so doing, they also produce *externalities* in that they benefit society at a

large rather than the individual user. This has, in the first place, induced societies to collectively organise and fund the provision of public goods and services and entrust their management to political decision-making rather than the markets (Stiglitz 1988). Thus, while the production process in the private sector is mostly a twofold relation between capital and labour, the provision of public services involves also the wider public – the taxpayers’ community - which funds and makes use of the publicly provided services. These considerations mean that the production process of public services is always a three-dimensional one whereby the wider public has a stake in the provision of services which shall be adequate to the needs of the community and efficiently realised at the minimum fiscal cost possible.

Most yet not all the public services which the state provides are essential services to the community. ILO regulation categorises as “essential services in the strict sense” all those services whose interruption would endanger the life, personal safety or health of the whole or part of the population (ILO 2006; art. 586 and 587). These services are healthcare services, fire-fighting, air traffic controls, police and armed forces, public or private prison services, water and electricity supply, etc. Other services, like postal services, refuse collection and the education sector are not considered essential services in the strict sense. However, these also constitute key services for the wellbeing of the community.

Furthermore, public services are – *par excellence* – labour intensive. This is to say that, in the process of producing public services, the labour factor is disproportionately more important – and costly – than capital goods (e.g. machinery). These are mostly services to the people performed through non-routine tasks that require human interactions. This is part of the reason why the economic literature has spoken of a cost disease which characterises the provision of public services (Baumol and Bowen 1965; 1966; Johnston 2011). The Baumol’s cost disease implies that the wage rates in public services are decoupled from their rate of labour productivity. Baumol and co-authors noted long ago that labour productivity in the kind of activities performed in the public sector (e.g. public administration, education, security, culture, etc.) does not rise (if it does rise at all) as fast as the industrial sector where productivity-enhancing technological change is the norm. Yet the public employers’ need to compete with the private sector for the recruitment of personnel forces public wages to rise in line with those in the private sector where labour productivity grows faster. This is where the market operates, indirectly, in public sector wage setting. In the long run, the supply of labour in the public sector labour market is a function of the wages paid by the public employers relative to those paid in the private economy. This forces public managers to remain attractive employers and ensures public employees will not be paid too little (Wellington and Winter Jr 1968) – in relation to their lower productivity rates.

The implications of these public services’ peculiarities are manifold. First, the formal allocation of fiscal resources to produce particular services and the determination of personnel’s pay rates therein is primarily political in nature and not economic – in the

narrow sense of a profit-making enterprise. It is a *political decision* on the merits of the quantity and quality of services to be produced and the extent to which the public personnel should be remunerated. Labour costs in the public sector do not endanger profit margins but rather constitute fiscal costs for the taxpayers. As such, these political decisions cannot but involve, directly or indirectly, the citizenry. They are, in other words, decisions on alternative uses of public money. For a private employer, in fact, in the face of any given fixed price of a product, an increase in unit labour costs must be compensated by an equal decrease of the profit margins hence of the employer's mark-up. The calculus in the public sector is of a different nature. Wages represent *fiscal opportunity costs* in the sense that benefits of other sorts are being missed by the community when a given amount of fiscal resources is earmarked for public sector wage setting. Public employers could instead direct these resources to alternative uses (e.g. public investment, social services, etc.) or to hoarding (i.e. creating a budget surplus) or to reducing the fees (if any) of public services provision.

#### 4.3.2 THE REGULATION OF EMPLOYMENT, TRADE UNION REPRESENTATION AND INDUSTRIAL CONFLICT IN THE PUBLIC SECTOR

In theory, legal arrangements which regulate public workers' rights to form and join unions may vary between two extremes (Ozaki 1987). On the one hand, both public employees and status civil servants may be denied associational rights altogether. On the other, these rights may be granted to the whole of the public sector workforce. In between these two extremes, intermediate situations may be found in which associational rights are granted to some groups of public employees while denied to others based on the essential public functions they perform. Generally, since the 1970s associational rights have been increasingly granted to public sector workers and today, the right of association is almost universally permitted to both status civil servants and contractual public employees (Bordogna 2007, 21). This is similar to the private sector.

Where the public sector differs is in the nature of the employment relationship with the state and the types of trade union representation. Following Keller (1981), two variants of employment relations have been distinguished in the public sector: the bargaining model and the legislation model. These have already been described above (see subsection 4.2.2 for a thorough discussion). Suffice it to say here that in the bargaining model public employees enjoy a legal status akin to that of private employees. In the legislation model, the civil servants are instead subjected to a public law labour relationship with the state which is meant to rule out the possibility of a conflict of interest between the public employer and the employees. The latter are required to act as loyal servants in the pursuit of the common good. Central to the legislation model is the denial of collective bargaining rights in favour of unilateral determination of employment and wage conditions through legislation and, often, the denial of the right to strike. These two types of employment regulation give rise to two models of trade

union representation in the public sector. Depending on the legal capacity to use strikes as a deterrence weapon, one may distinguish between *public stage bargaining* and *political stage bargaining* (Schmidt and Müller 2018).

When unions lack the legal capacity to strike, they will have to advance public employees' interests through political stage bargaining. This mode of interest representation is specific to the public sector given its double nature of political employer. Since employment and wage terms for status civil servants are determined unilaterally through legislation, to advance their claims unions will have to interfere with this process to try to influence legislators in their favour. Differently from industrial disruption in the private sector, this public-sector-specific strategy is subtler and relies on lobbying and networking, often behind closed doors and within policy circles. On the one hand, the fact that public employers are political agents empowers civil servants' unions, whose members and their families vote, to threaten to sanction elected officials at the next elections (Keller 1981). On the other, professional civil servants' unions generally rely on very qualified lawyers, trained to defend their members in legal complaints vis-à-vis the state on the basis of the constitutionally-guaranteed status of the civil service and its very nature of public law. A prominent example is the alimentation principle enshrined in the German *Grundgesetz* (Germany's Basic Law) which ensures civil servants a constitutional right to adequate remuneration.

When public employees have the legal capacity to strike, "industrial action" is an option on the unions' menu. They can apply pressures to employers in a way that is similar to that of the private sector. In fact, this is also a mode of advancing public employees' interests vis-à-vis employers by causing some sort of disruption. Yet public sector industrial action works differently in that it is always aimed at affecting primarily the wider public and, through it, apply political pressure on the public employers. The unions' deterrence mechanism in public stage bargaining works through the political pressure which citizens or other organised groups of customers will apply toward the public employers for a quick resolution of the conflict (Wellington and Winter Jr 1968). This involves a triangular political relationship between the public employers, the unions and the citizens who fund and avail themselves of the services being disrupted. This public-sector-specific type of political collective action follows from the nature of the public services described above. Differently from the private sector where surplus-value is produced, strikes in the public sector do not disrupt the process of profits accumulation. So, while in the private sector strikes constitute a deterrence instrument of an economic nature, in the tax-financed sector, strikes which interrupt the provision of public services may instead even lower the production costs public employers face (e.g. personnel and other production costs such as lighting and heating of childcare facilities, schools, etc.). Thus, a strike in the public sector is a risky strategy for the unions which, to succeed, depends necessarily on the capacity of the unions to mobilise the public behind its strategy – or

at a minimum to avoid its hostility. But nothing ensures that the public will align with the public employees. Quite to the contrary, since public sector strikes disrupt crucial services to the community, rather than the employers, it is the citizen-customer that is primarily inconvenienced by a public sector strike. Thus, the capacity to strike successfully in the public sector depends also on the prevalent mood of the public opinion and people's perception of the public service and its employees. The unions must convince the public about the legitimacy of their demands and the citizenry must approve of the unions' cause. But while this may be an empowering condition for unions to strike, in case of conflicts, the success of public sector unions depends on their power resources.

#### 4.3.3 PUBLIC SECTOR UNIONS' POWER RESOURCES

The literature on trade unions' power resources is premised on the assumption that the workforce successfully advances its interests through the collective mobilisation of power resources. Power is thus intended as "power to" successfully assert, within a given institutional context and social relationship, the interests of the workers despite resistance. In fact, different from the public employers, who are sovereign legislators, the workforce and their associations do not dispose of the legal capacity to deploy unilateral "power over" opponents. Four types of power resources can be identified (Lévesque and Murray 2010; Schmalz and Dörre 2014; Silver 2003; Wright 2000) whose successful use increases the probability that workers and/or their associations will be in a "position to carry out (their) will despite resistance" (Swedberg and Agevall 2005, 205) from the employers.

*Structural power* is linked to the position of workers in the production system. It can be intended as *workplace bargaining power* or as *marketplace bargaining power*. The former is available at the level of the individual worker at the workplace and depends on the capacity to cause disruption in the process of capital accumulation thus creating direct economic losses to the employers. In the context of the public sector, as described above, disruptive power should be analysed not in relation to the public employers *per se*, but rather *vis-à-vis* the wider public. Disruptive power depends on the capacity to create disruption in the everyday life of the citizens-customers who make use of public services. Marketplace bargaining power depends on the strength of the worker's position in the labour market. The basis for this strength is given by certain rare skills or qualifications which the worker possesses. Power results from the fact that the public employer needs the worker's skills more than the employee needs that particular employer to be employed. The skilled worker is in a position to negotiate better terms of employment while threatening to find a job somewhere else.

*Associational power* is the result of workers forming political or trade union's associations. It is collective rather than individual and rests on the capacity of the collective actor to elaborate and execute strategies to advance their interests.

Associational power can be deployed at the workplace level through staff councils, at the sectoral level generally via trade unions' action, or at the political level. Differently from the private sector, in the public sector, the sectoral and the political cannot be disentangled and associations' attempts to deploy power resources in public sector wage setting are always also a way to deploy power in the political arena. Associational power may rest on different factor besides the mere number of members. Associations need infrastructural resources (financial and building capacity, human resources, etc.) to be able to carry out their work. Furthermore, associations need the capacity to mobilise their members in collective action. This requires a "willingness to act" by the workers and some forms of internal cohesion and solidarity.

*Institutional power* depends on legal provisions which define unions' participation, rights and duties in given circumstances. Legal provisions grant both legal rights and constraints to the unions and thus institutionally enhancing/reducing their power to act in order to assert their interests. This type of legalistic power resource acquires great importance in the context of civil servants' wage determination whereby the status of civil servants – who may lack the right to strike – is protected by constitutional provisions which specify the rights and duties of both the sovereign employer and the "loyal servant of the state". Professional unions require trained lawyers to challenge the behaviour of public employers which they retain detrimental to the workforce they represent before constitutional or administrative courts.

*Societal power* is understood as the capacity for the unions to enter coalitions and join forces with other societal groups or to mobilise society's support for the union demands. Thus, societal power can be understood as *coalitional power* and *discursive power*. This type of power resource too acquires a genuinely political character and retains extreme importance in public sector wage setting. Coalitional power means the capacity for unions to pursue common goals with other social actors by entering into mutual commitments. Successful coalition building by one trade union organisation consists of boosting the latter's associational power by either mobilizing in its favour the allied actor's resources or by receiving from her material, political or discursive support. As for discursive power, the reasons are straightforward. As discussed above, in the public sector the mode of trade union interest representation is a public and a political stage bargaining depending on the workers' legal right to strike. In the former, for public strikes to succeed the unions need discursive capacity to convincingly talk the citizenry behind their cause. Otherwise, public hostility will undermine unions' mobilizing capacity and, instead, empower the public employers to resist the unions' demands. In political stage bargaining, given the lack of the strike option, unions need the discursive capacity to successfully convince those politicians acting within the policy network charged with drafting legislation on civil servants' employment conditions.

After having introduced the two sets of wage setting actors in the public sector, in what follows I introduce the institutional setting within which wage setting interactions take place.

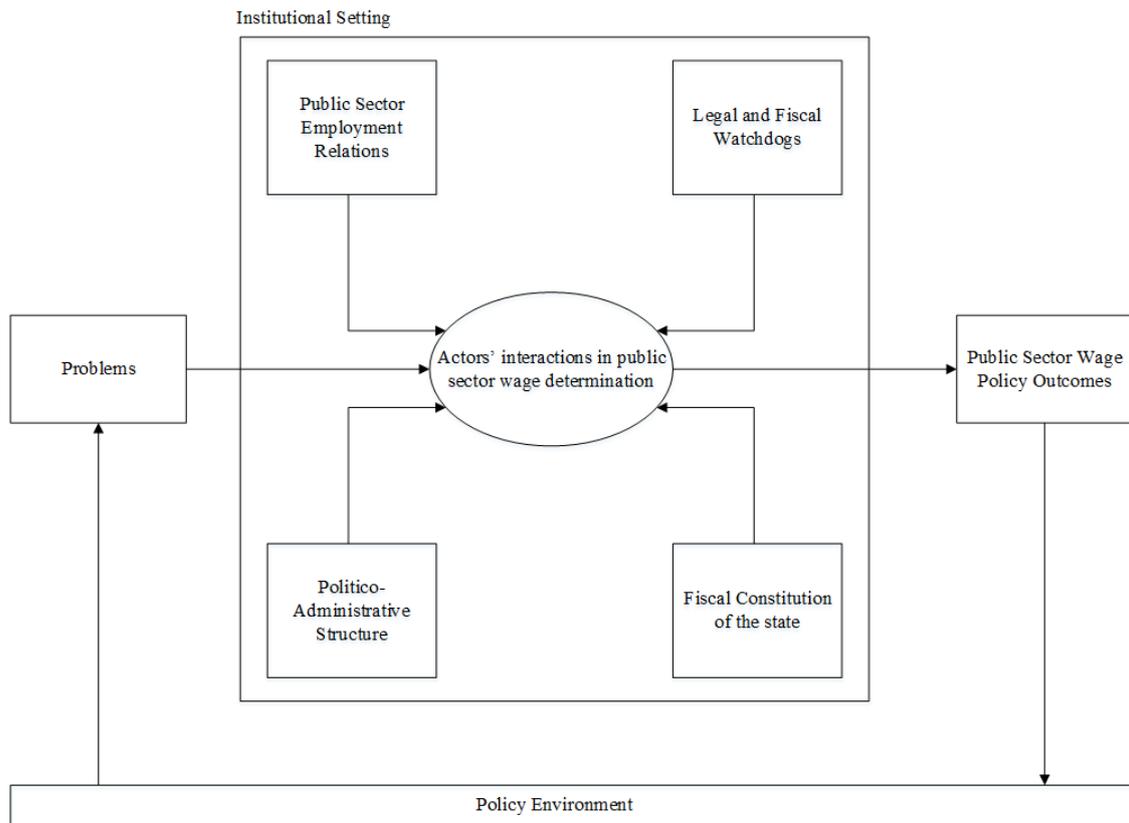
#### 4.4 THE STATE AS AN INSTITUTIONAL CONTEXTUALISATION: A FOUR-TIER ANALYTICAL FRAMEWORK FOR THE STUDY OF PUBLIC SECTOR WAGE SETTING

To explain policies through structured political interactions, I develop an analytical framework that provides guidelines for the search of explanations in real situations. The framework is meant to provide a static representation of the state as an institutional contextualisation. It theorises the institutional factors which structure the capacity of public employers and unions to make strategic choices during processes of public sector wage determination. It is meant to guide us in the empirical research through a theory-based understanding of how to identify the actors involved in the policy, their salient characteristics and action resources, the institutional setting in which they interact and their modes of interaction. This means, in other words, to have theoretically-grounded *institutionalist working hypotheses* that define which institutions matter and how they matter in structuring political interactions that produce policy (Scharpf 2000).

The analytical framework for the analysis of public sector wage setting which I develop is composed of four building blocks: public sector employment relations, the politico-administrative structure of the state, the fiscal constitution of the state, legal and fiscal watchdogs. To preview, the diagram in figure 9 provides a visual simplification of the analytical framework.

Public sector wage policy constitutes an ongoing policy problem (left-side square in the diagram) for governmental authorities. This has to do with governments' fundamental responsibility for the maintenance of the state's public administration. To the extent that the state must survive, it needs to execute its functions. Since Montesquieu (1748) we know that governments engage with three sorts of powers, namely the legislative (to make laws), the executive (to implement and administer these laws) and the judiciary (to lawfully judge upon controversies in societies). To execute these tasks, the state requires a staff. If the staff is to provide manpower, it needs to be remunerated. Compensation, like in any other sector of the economy, must be adjusted according to macroeconomic developments in the economy. This is what constitutes the wage setting problem in the public sector. To ensure services provision, public employers continuously re-negotiate the terms of public employment through wage bargaining and/or unilateral legislation (depending on the legal setting). For this purpose, they must engage in interactions with their respective labour counterparts (central circle in the diagram). These interactions are aimed at producing wage policy (right-side square) which, by adjusting the terms of pay and employment to current economic and social developments, solves the wage setting problem.

Figure 9: A four-tier analytical framework for the study of public sector wage setting



Source: Author's elaboration. Adapted for current purposes from Scharpf (1997b, 44).

Who the specific counterparts are depends on those actors whom the legal system attributes the competence to take part in the specific set of policy interactions. What these actors can/cannot do and how they do depends on the legal/institutional setting within which these interactions take place. As mentioned already, the state should be understood as a “strategically selective” contextualisation (large external square) in that its structured institutional setting presents state actors with opportunities and constraints which shape their strategies and preferences (Jessop 1990).

I have identified four key institutional domains which concomitantly structure processes of public sector wage setting. The system of public sector employment relations and interest representation (upper-left square within the institutional setting square) tells us *who* is in charge of determining/negotiating *what*, with the institutionalised involvement of *whom* and *how*. The politico-administrative structure of the state (bottom-left square) tells us what the structure of the polity is, how is the public administration organised within it and how political authority is dispersed within the contours of the state. The fiscal constitution of the state (bottom-right square) informs us about the capacity of public employers to raise the revenues necessary to meet the fiscal costs of public sector wage setting. Lastly, legal and fiscal watchdogs (upper-right square) represent other state actors next to the public employers who *may*,

within the state's legal contours, constrain or block altogether public employers' intended wage policy. After this brief preview, I discuss in greater detail the theoretical aspects of each building block.

The system of public sector employment relations and interest representation is determined by country-specific legal provisions. A more thorough analysis is not necessary here for the regulation of public employers and trade unions' involvement in public sector wage determination and employment relations has been already introduced in sub-sections 4.2 and 4.3 respectively. Suffice it to say that, when analysing wage policy we need to comprehend how legislation regulates employment relations in the public sector. Legislation defines the actors involved in wage setting (who is management and who is labour); determines the modes of interest representation; regulates whether wage determination occurs via unilateral legislation or collective bargaining and as a result the structure and the level of wage bargaining. In so doing, legislation also shapes the mode and the extent to which public employers can deploy their sovereign authority in the processes of public sector wage determination.

The politico-administrative structure of the state is a crucial institutional domain for the study of public sector wage setting. Understanding the institutional architecture of the state and its public administration is necessary to comprehend the organisational features of the administrative machinery. What requires an understanding is the type of state we are analysing; how political authority is distributed within it and how the state's public administration is structured and functions. This enables us to understand *who* has the legal competence to do *what* within *what type* of state administration. Understanding the distribution of legal competences within the state is in fact a precondition to disentangle conflicts of interests which cause state actors to be internally divided. This is because the distribution of legal competences shapes the distribution of public personnel within the state's institutional entities. On the first aspect, the structure of the state defines how the polity is organised and functions in terms of vertical levels of government (e.g. central vs sub-national governments) and horizontal administrative entities (e.g. ministries, agencies, etc.). Policy actors within the state contextualisation act as institutional representatives of their respective organisations. Some of these state actors may or may not be involved in processes of public sector wage setting depending. This depends on how the system of public sector employment relations regulates public sector wage bargaining in the polity. Yet the actions as well as the preferences of those actors that are indeed involved in public sector wage setting will be tied to the administrative entities they represent.

On the second aspect, the distribution of legal competences (vertically and horizontally) shapes the distribution of personnel within the various administrative units of the state. This is a fundamental aspect to derive public employers' preferences which pave the way to intra-state conflicts of interests. Each administrative unit of the state must employ a varying number of employees depending on the entity and the

nature of the tasks it is charged with. Of the three core functions of the state, it is executive/administrative powers that necessitate a disproportionately higher concentration of manpower. As a result, labour costs will be much higher for those public employers whose administrative units are charged with these types of functions. Public services such as education, health and social services require much greater manpower to be accomplished than legislative and judiciary powers. The division of powers within the political system thus roughly determines the distribution of public personnel employed within its administrative units. This in turn defines the *stock of labour costs* which a public employer is confronted with. The implication is that, the more an administrative unit is charged with the provision of labour-intensive public services, the higher its stock of labour costs will be, due to the greater manpower required for the execution of the assigned competencies. From this we can derive that the greater the initial stock of labour costs is, the more salient the problem of setting wages becomes for that public employer. For the books of a given administrative unit, personnel costs represent, at any given point in time, a stock of outlays which needs to be financed. Wage bargaining is nothing else than negotiating over the *flow* of fiscal resources which will have to be added to the initial stock of personnel costs. When in charge of earmarking the fiscal resources to finance wage setting, employers facing higher labour costs have a strong structural incentive to minimise wage increases. If the distribution of competencies is asymmetric within the state (e.g. between the central and the regional level), diverging material preferences for wage setting are likely to emerge among the public employers.

In all, the more concentrated employees are within a specific administrative unit, the higher the personnel costs which that employer will have to come to terms with. This has to do with the distribution of political authority within the state. In this context, the wage bargaining preferences will be different for different employers largely depending on the percentage of personnel costs in their total expenditures:

*public employers with a higher stock of labour costs are likely to have a stricter preference for a public sector wage policy which minimises the flow of additional fiscal resources to be earmarked for personnel expenditures*

However, this reasoning only sheds light on the expenditures' side. To be complete, one must look also at the public employers' financial *ability to pay*, i.e. the revenues' side. This is where the fiscal constitution of the state comes into play in that it consists of the set of legal provisions which regulate public financing within the state. The fiscal constitution of the state refers to the regulation of governments' competences to raise revenues through taxation and borrowing. It is generally defined by the constitution and other legal provisions. Taxing and borrowing powers, together with exogenous factors, determine the *fiscal space* available to each public employer. While fiscal powers are regulated by tax legislation in the polity, exogenous factors may also intervene which are beyond governments' control. They are contingent on the policy environment, e.g.

economic cycles tend to generate fiscal cycles due to patterns of higher/lower returns and lower/higher social spending in good and bad times. All else being equal:

*the more constrained the capacity to manipulate revenues at will is (through tax revenues and/or borrowing), the more an employer's fiscal space is constrained in the face of a given level of structurally increasing outlays for personnel expenditures.*

Similarly, the more an exogenous factor reduces/increases the government's revenues/outlays, the tighter the fiscal space becomes. There is here an asymmetry between the expenditures and the revenues side of the public employers. The former tends to grow structurally over time. Revenues' growth, instead, is constrained by the difficulty of imposing higher taxation on private capital in a context of global markets and on citizens who, by voting, determine whether or not the elected public employers retain their job in office (Spizman 1980). Labour costs have an inherent tendency to increase. They tend to increase exponentially for those public employers with an initially higher stock of personnel costs (because the % increase is multiplied by a higher base). To cope with increasing costs, public employers can rely neither on market prices nor on significant productivity enhancing measures. They depend inexorably on the capacity of the state's fiscal system. This system needs to generate increasing revenues in order to meet rising expenditures so as to escape a crisis of the tax state (O'Connor 1973; Schumpeter 1918; Streeck 2014, 70-78). When this is not the case, the fiscal space will become ever tighter over time. Expenditures will have to be reduced and/or covered by deficits, if possible.

In all, the contention here is that a public employer's *ability to pay* the stock of labour costs depends crucially on the fiscal space at her disposal, i.e. the ability to pay the personnel costs is higher the looser the fiscal space is and *vice versa*. The fiscal space of each public employer is determined by two factors. The first is the employer's *fiscal autonomy*, i.e. the legal capacity to manipulate revenues at will, either through the taxation system or via borrowing. The second relates to environmental factors, i.e. favourable/unfavourable economic cycles and/or exogenous shocks which enlarge/diminish an employer's fiscal space beyond her control. Booming economic phases tend to produce higher tax revenues and lower social expenditures thus enlarging the fiscal space to manoeuvre in public sector wage policy. The opposite occurs when the economy slows down. In this sense, Gourevitch (1986) would distinguish between implementing policy in *good* and *hard times*.

Combining the employers' revenues and the expenditures dimensions yields a fruitful two-by-two table, from which we can discern the micro-foundations of public employers' preferences in public sector wage setting. These can be derived from the interaction between the stock of labour costs which employers face (expenditures side) and their available fiscal space (revenues side).

Table 2: Micro-foundations of public employers' preferences for restraint in public sector wage setting

		Employers' stock of labour costs	
		High	Low
Employers' fiscal space	Loose	Weak preference for restraint	No need for restraint
	Tight	Very strong preference for restraint	Moderate preference for restraint

The urgency for a public employer to contain labour costs depends on the interaction between the expenditures and revenues sides of public employers' budgets. On the revenues' side, employers' ability to pay depends at any point in time on the available fiscal space, which can be tighter or looser. Employers' fiscal space is the primary driver in this mutual interdependence for the incapacity to meet financial needs may threaten the very survival of the organisation. In this context, the tighter the fiscal space becomes, the more salient the problem of containing additional personnel costs will be for public employers. By the same logic, the higher the stock of labour costs of a given administrative unit, the more urgent the need to minimise the financial burden of wage setting is in the first place. The combination of these insights gives us four abstract scenarios.

In situations in which employers' fiscal space is loose and labour costs are high (upper left quadrant), containing additional costs ensuing from wage bargaining constitutes a problem of moderate saliency. We can reasonably expect public employers in such a situation to have a weak preference for restraint, i.e. governments do not have the need to forcefully push through a policy of cost containment since the fiscal resources available are somehow adequate to meet personnel expenditures. In other words, a looser fiscal space increases public employers' ability to pay. Disposing of a loose fiscal space in conjunction with low labour costs (upper right quadrant) is the best position for a public employer. This removes the preconditions for a policy of wage restraint altogether. In such a scenario, public employers have little or nothing to fear from wage setting in terms of fiscal costs. We should in theory expect no need for a policy of public sector wage restraint.

It is tighter fiscal space instead which brings troubles because it decreases the employers' ability to pay. The need for restraint increases the more the employers' fiscal space tightens up. So, when the fiscal space shrinks, we may expect a relatively stronger preference for a policy of wage restraint to emerge even among public employers with a relatively low stock of labour costs (lower right quadrant). However, being in a situation of tight fiscal space within an administrative unit which is

confronted with high labour costs (bottom left quadrant) is the worst scenario, both financially and politically. This is because the urgency to pursue cost-containment measures is strong and the political backlash will be high given the wide constituency which will be affected by the austerity measures. In this case, containing the increase of personnel expenditures acquires extreme saliency to the point that the very organisational survival *may* be threatened. We should expect public employers in such a situation to have an extreme preference for a policy of public sector wage restraint which minimises the flow of additional fiscal spending for personnel. When both confronted with tighter budgets, the difference between employers with a high stock of labour costs and those with a smaller one is that for the former, the urgency to implement restraint becomes exponentially urgent due to the higher base of labour costs by which the wage increase will be multiplied. Given the exponential costs of wage setting, for these employers restraint may become a matter of financial survival for the organisation. This is the difference between a very strong preference for wage restraint of the former and a moderate preference for wage restraint of the latter.

At any rate, it is during situations of financial strain that we should expect public employers to be more likely to try to deploy their sovereign authority in public sector wage setting. Through their state power, public employers in dire straits are likely to try to enforce restraint via *hierarchical coordination* (Scharpf 1997b, 171):

*primarily out of fiscal considerations, public employers will try - if necessary and legally possible - to make use of their sovereign authority to override unions' opposition and contain if not eliminate altogether the fiscal costs of wage setting.*

Among the cost-containment measures which can be taken during these situations, it should be noted, squeezing wages is but one among the possible options on the menu. When in need to reduce the fiscal costs of public sector wage setting, public employers can pursue a combination of the following cost-cutting measures:

- *Negotiate or impose unilaterally low wage increases. In extrema ratio negotiate or impose a wage freeze ( $\Delta = 0$ ).*
- *Resort to a so-called "zero months" strategy. This means public employers strategically delay as much as possible the entry into force of the new wage agreement. The more "zero-months" can be extracted, the more the fiscal savings. This is also part of a "wait-and-see" strategy. For the employers it is convenient to wait as much as possible until the labour part takes the lead in the renewal of the contract.*
- *Resort to an extension of the contract duration. The longer the duration of the contract signed the more convenient and predictable it is to the employers because pay adjustments drift apart from developments in the real economy.*
- *Curtail qualitative aspects of the public employment relations which have quantitative costs (e.g. the right to access thermal treatment and other care-related provisions).*
- *Curtail fringe benefits attached to the employment relation.*
- *Reduce the size of the public sector by scaling down employment if legally possible or freeze turnover and let employment shrink due to the lack of replacement.*

- *Privatise and outsource public services contracting them out to private agencies*
- *Extend working hours.*

After having analysed the three key institutional domains, I conclude now with the last important aspect of the analytical framework, the presence of legal and fiscal watchdogs, organs of modern democracies, charged with the task of counterweighting governmental authority within the polity. These are generally determined by constitutions and other legislation. Public employers, although maintaining their sovereign prerogative to act unilaterally to coerce societal actors, do *not* act in a vacuum. Modern liberal democracies are founded on systems of *checks and balances*, enshrined in constitutions and meant to keep sovereign authority under legal and institutional control. Prominent examples are constitutional or administrative and labour courts or parliamentary budgetary offices. Another important example is the presence of an independent central bank, capable through the determination of monetary policy of imposing lines of conduct on governments' actions. What needs to be assessed is whether such bodies impose legal and institutional constraints on governments' policy action. In other words, it needs to be assessed whether these organs hold the status of institutional veto players, i.e. institutional entities whose agreement is required for the implementation of a given policy (Tsebelis 1995). In this respect, constitutional courts could impose on the government given courses of action in public sector wage policies which, if unconstrained, the government would have refrained from. On a similar vein, fiscal watchdogs, common in parliamentary systems may retain the ability to act as institutionalised veto players, constraining governments' capacity to enact discretionary fiscal policy, i.e. its ability to pay.

#### *4.5 WAGE POLICY REQUIRES FISCAL POLITICS*

The previous sub-section has introduced the state as an institutional contextualisation. Within this state contextualisation made of rules and institutional entities, policy outcomes are produced by the interactions of intentional policy actors who mobilise resources and assemble political coalitions necessary to transform their preferences into outcomes. The central contention of this dissertation is that public sector wage policy *is* fiscal policy. This constitutes the departing point from the state of the art of public sector wage studies in CPE. Taken seriously, this claim implies that one cannot understand wage determination in public services without entering the realm of budgetary politics. This is because the one follows from and is dependent on the other. This means that the employment relations arena, in which wage negotiations take place, cannot be analysed separately from the fiscal arena, in which financial decisions are taken: *their relationship is dialectical*. Public sector wage setting, in other words, *shapes and is shaped* by fiscal policy.

There is hardly anything more political than fiscal policy. The adoption of a given wage policy in the public sector is thus ultimately a political decision taken also - and sometimes primarily - in the realm of fiscal policy and for budgetary reasons. I concur with Gourevitch (1986, 19) that to understand policy choices “we must understand the politics that produces them.” Since the state’s financial resources are limited, discretionary decisions are to be made as to how to divide funds among alternative uses for which political parties, interest groups and administrative agencies (etc.) compete. Indeed, the size and shape of the budget is a matter of serious contention in political life: it is the mirror image, expressed in monetary terms, of governmental activity. As Wildavsky (1964, 4) has vividly put it “(i)f politics is regarded in part as conflict over whose preferences shall prevail in the determination of national policy, then the budget records the outcome of this struggle. If one asks, “Who gets what the government has to give?” then the answers for a moment in time are recorded in the budget. If one looks at politics as a process by which the government mobilises resources to meet pressing problems, then the budget is a focus of these efforts”.

To investigate the politics of public sector wage policy requires an investigation of societal political developments and class relations through the lenses of public finance and fiscal policy. Schumpeter had it right with his plea for looking at the state, “its nature, its forms (and) its fate, as seen from the fiscal side” (1918). In fact, utilizing the lenses of fiscal policy to study public sector wage setting facilitates the research endeavour in two crucial ways (Schumpeter 1918). Fiscal policy has *causal significance* insofar as *fiscal events* are an important element in the causation of public sector wage policy in that the state is the ultimate political paymaster. Fiscal policy has *symptomatic significance* for everything that happens in public sector wage policy must have its fiscal reflection in the budgets. Differently from the private sector, in fact, the fiscal nature of wage policy in the public administration implies that to be enacted lawfully a wage policy will always have to go through a budget law.

To understand the adoption of wage policy in the public sector we thus must understand the politics of fiscal policy. This means to understand what type of action resources do state actors mobilise and which coalitions they assemble in the political process of determining the fiscal resources which will have to be earmarked in budget laws. It is through fiscal policy which the public employers will ultimately pay for the additional flows of personnel costs. Determining the fiscal resources which will pay for wage policy is the central political process in the adoption of public sector wage policy. Either decreed by unilateral legislation or through collective bargaining, a wage policy in the public sector, to be adopted, must obtain the support of those state actors who have the political authority to eventually enact it.

Within the state-centred institutionalist framework developed here, as recommended by Scharpf (1997b, 43), we need to first identify the set of interactions which produces the policy outcome to be explained. This allows us to identify the actors involved and to study their specific preferences and capabilities as shaped by the institutional

configuration introduced above. While actors will have preferences for certain policy outcomes, the translation of their preferences into policy outcomes depends on the successful mobilisation of resources that allow an actor to overcome conflict and competition with rival actors in the policy process and within the institutional setting. Capabilities, similar to the concept of power resources (Korpi 1985), refer to all “action resources that allow an actor to influence an outcome in certain respects and to a certain degree” (Scharpf 1997b, 43) (see section 4.2 for the employers’ side and 4.3 for the unions). These may consist of physical resources such as money, technological capabilities or asymmetric access to information. Most importantly for policy research, capabilities may originate in the very institutional setting. These are actors’ capabilities of legal nature which define competencies, specify the terms of actors’ participation in given processes or bestow veto rights in certain phases of particular policy processes.

In public sector wage setting there is a central asymmetry of power between “capital and labour” which cannot be ignored. Public employers are political sovereigns who, in principle, have the legal authority to give course to unilateral action and override the decision preferences of other actors. Yet coercive power and physical sanctions run also the risk of creating alienation and a sense of illegitimacy (Korpi 1985; Scharpf 1997b) which endangers the survival in office of public officials. It is thus not so clear *a priori* that the public employers will be always willing and capable to exercise unilateral action in public sector wage setting. Furthermore, the suggestion of this dissertation is that the very capacity of public employers to deploy sovereign authority is *de facto* undermined by the fragmented and decentralised nature of modern States. Public employers are not unitary actors. They are policy actors which partake of their policy prerogatives with a constellation of other policy actors within the state’s configuration. Conflicts of all sorts may thus emerge when it comes to the determination of budgetary and wage policies. This has implications for their capacity to mobilise action resources. Public employers must overcome their own collective action problems before being capable of adopting wage policies.

What matters in public sector wage setting is not so much States’ sovereign authority *per se* but rather to what extent and under which conditions do public employers deploy their sovereign power. I have hypothesized that the capacity of the public employers to deploy their sovereign power in public sector wage setting is contingent on the following two conditions. First, the legal system must necessarily grant public employers the capacity *to act unilaterally in wage setting*. Without this legal capacity, or if the state is constrained in its actions by a third-party legal institution (e.g. constitutional/administrative/labour courts), no sovereign power can be mobilised in public sector wage setting through unilateral legislation. Secondly, when they are internally divided, to deploy their sovereign authority as a legal action resource, public employers must first overcome their collective action problems. To do so, a process of coalitional formation *within* the public employers’ camp will have to occur so as to assemble the political support necessary for enacting wage policy unilaterally.

If, instead, the legal system determines that the regulation of public sector employment relations occurs through collective bargaining, the public employers will have to engage in negotiations with the unions within the legal framework of independent bargaining. To “act” as wage setters thus the public employers need to form a united front through which to enter the process of wage negotiations. In this process, they will have to act as unitary actors in opposition to the labour front. The outcomes of public sector wage setting through collective bargaining negotiations is thus contingent on the participants’ power resources and environmental factors.

Thus, both in order to act unilaterally and to enter collective bargaining, there will have to be a process of coalition building within the public employers’ camp. Public employers will have to forge political coalitions among themselves and/or with other state actors to push for desired policies within the contextualisation of the state. Studying these processes of political mis/alignments and coalition formation among the public employers is the empirical task which is now undertaken in the case study.

**PART 2. FROM REUNIFICATION TO A NEW INSTITUTIONAL  
EQUILIBRIUM: THE TRAJECTORY OF WAGE RESTRAINT IN  
THE GERMAN PUBLIC SECTOR**

## CHAPTER 5. THE GERMAN INSTITUTIONAL SETTING IN THE EARLY 1990s

This chapter sets the stage for the second part of the dissertation, which is empirical in nature. While the following chapters will deal with the historical reconstruction of public sector wage setting since Germany's reunification, this chapter describes the characteristics of Germany's institutional setting. The chapter is structured along the lines of the analytical framework introduced in chapter 4. Thus sub-section 5.1 elaborates on the features of Germany's politico-administrative system. Sub-section 5.2 describes the system of public sector employment relations and interest representation. Sub-section 5.3 discusses the fiscal constitution of the German state and, lastly, sub-section 5.4 deals with legal and fiscal watchdogs which may constrain governments' actions.

### 5.1 THE POLITICO-ADMINISTRATIVE STRUCTURE OF THE STATE

Germany is a civil law country. The creation of the current political system results from the approval of the 1949 Basic Law, the constitutive act giving birth to the Federal Republic of Germany. After the destruction of the Nazi regime, Germany was subjected to military occupation by the allied powers. Its state was crafted in the territorial zones occupied by three victorious nations: France, the United Kingdom and the United States. A convergence of preferences had emerged among the allies on the necessity to institute a territorially decentralised political and administrative system. This was meant to protect the country's democratic institutions and prevent the re-emergence of centralizing and totalitarian political movements (Katzenstein 1987, 16). The type of federal system designed made sure a decentralised system be put in place in which Länder's governments would obtain key important powers vis-à-vis the Federation. After all, the German States existed before the Federation was set up and their representatives played a key role in negotiating the Basic Law's final text with the allies (Gunlicks 2003, 53-54).

Germany's constitutive act created a "democratic and socially conscious federal state", formally composed of two tiers of government, the Federation (*Bund*) and the States (*Länder*). The States joined the Federation while retaining their statehood. Municipalities (*Gemeinden*) and Counties (*Kreise*) constituted the local self-government. They form a constituent part of the Länder by whom they are directly supervised (Wagener and Blümel 2001, 95). Germany has three administrative levels: the central government represented by the Federation and two levels of subnational government, the States and the municipal governments. There exist three types of Länder: the larger territorial Länder, the smaller Länder and the city-States. Both the

States and the municipalities are guaranteed the right to organise their administrations as they see fit.

Executive authority in the Federation rests on the Chancellor and her cabinet of ministers. Similarly, at the Länder level executive authority belongs to the minister-president, the secretaries of state and the cabinet (Frank 2001). Local governments' constitutions are a matter subjected to the Land's authority. Länder have the responsibility to regulate the organisation of their municipalities. As a result, different arrangements exist that define the role and status of executive officers across the States. In general, executive power is held by the leader of the city council (generally the mayor) or can be shared with other administrative figures (Lehmann-Grube and Dieckmann 2001).

The Bundestag, the Bundesrat and the Chancellor all participate in the legislative process at the federal level and can introduce bills to the lower chamber. Legislative power is *unequally* shared between the Federation and the States. The Federation holds exclusive power to legislate on specific subjects as well as concurrent legislative powers which are shared with the States. Yet Länder's legislative competencies are mostly residual. In matters where the Federation holds exclusive powers, States can legislate only when expressly authorised by the Federation. In matters of concurrent legislative power they can legislate only if and to the extent in which the Federation has not already made use of its power to legislate on a given issue. In the practice of government, this means that most of important legislative powers are exercised by the Federation (Federal Ministry of Finance 2009). Gunlicks (2003, 56) argues that in today's Germany "there are relatively few legislative powers that have not been granted to the federal level by various means".

To the contrary, the power to implement and administer most federal legislation is assigned to the States and through them delegated<sup>19</sup> to the local municipal governments who bear the lion's share of administrative tasks (Wollmann 2001). This implies that the Federation's executive powers and administrative capacity are extremely weak. A minority of public employees are thus employed at the federal level. The Federation has to rely on the subnational governments' administrations for the implementation of federal legislation. As a result, the vast majority of public personnel - either with the legal status of civil servants (*Beamte*) or that of public employees (*Tarifbeschäftigte*) - are employed by the States and the municipalities. Most of administrative functions performed by municipalities are imposed on them by the laws of the Federation and, especially, the Länder. Few remaining decisions are taken by the local representative assembly.

All Länder have unicameral legislatures. Instead, the federal legislature is bicameral. It comprises the *Bundestag* (the lower chamber) whose representatives are directly

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<sup>19</sup> For an informative overview on the distribution of tasks and responsibilities across governmental levels see Thieme (2001).

elected and the *Bundesrat* (an upper chamber) composed of representatives of the States' governments. Since the composition of the *Bundesrat* changes repeatedly according to election results at the *Länder* level, there is often the possibility of a divided parliamentary control of the two chambers. This occurs when majorities in the two chambers are held by different party coalitions. Since most of the important federal legislation requires two-thirds majorities in both chambers, divided majorities pose a challenge to the legislative process. Opposing parties can veto/amend legislation by using their majority to block or force changes in several government initiatives. The logic of voting differs across the two chambers. Voting in the *Bundestag* occurs along party lines whereas voting in the *Bundesrat* mostly follows from States' interests (Timmins 2000, 80). Around 85 to 90 percent of all votes cast in the *Bundestag* are expression of party votes, while decisions in the *Bundesrat* are generally reached through political compromise among *Länder* governments (Langenbacher and Conradt 2017, Ch. 7). The Basic Law assigns to the *Bundestag* primary legislative functions. Yet it also stipulates that around 50 percent of federal laws require the approval of *Länder's* governments in the *Bundesrat* (Benz 1999, 56). This is the case particularly for federal legislation which affects *Länder's* financial interests and requires their implementation. Hence, the enactment of federal legislation depends crucially on the agreement of *Länder* governments who have for this reason become a powerful and sometimes disruptive veto player in national policy making (Thelen and Karcher 2013). Scharpf (1988) has famously spoken of a *joint decision trap* to describe Germany's legislative system as an institutional setting in which unanimity decision-making leads to the adoption of suboptimal policies and a status quo bias.

The financial architecture of the system (described at length below) is also determined by federal tax legislation but revenues are shared by *Länder* and municipal governments and through a system of predetermined vertical transfers from the Federation and horizontal transfers among the States. Thus, while most of the administrative responsibilities fall upon subnational governments, *Länder's* fiscal autonomy is severely curtailed by the centralised regulation of public finance. In terms of federal fiscal policy, the Finance Ministry is responsible for drafting the federal government's budget and monitor spending by the various departments. It acts as the financial watchdog over the state's agencies. Since the Finance Ministry must approve all government proposals dealing with money, it has *de jure* and *de facto* a veto power over any spending program regardless of whether they are favoured or not by the Chancellor (Langenbacher and Conradt 2017, 241). This power is grounded in the constitution which legally makes the Finance Minister the most important member of the government after the Chancellor. In the course of the case study, we shall see how the federal Finance Minister Theo Waigel played a crucial role in enforcing public sector wage restraint before the fiscal year 1997 to enable Germany meet the provisions of the Maastricht Treaty.

Scholars have described Germany as a centralised society with a decentralised “semisovereign” state (Katzenstein 1987). It is an asymmetric federal system (Benz 1999) characterised by a “vertical decoupling” between the Federation’s legislative functions and the States’ administrative responsibilities (Wollmann 2001, 154). The Basic Law confers substantial political authority to the States in three ways (Langenbacher and Conradt 2017, 306-07). First, it assigns to the States legislative powers on key matters such as education, police and internal security, administration of justice, media and communication and the organisation and regulations of the bureaucracy. Second, it charges the States with the responsibility for the administration of federal law and the collection of the taxes being levied across the country. Third, it ensures the political representation of States’ interests via the upper chamber of the German federal legislature.

Of great importance for the functioning of the German political and economic system is also a network of “para-public” institutions which have historically played important policy functions, inducing political and economic stability in the country (Katzenstein 1987, 58-80). Social security funds administer the provision of insurance against illness, accidents and old age, while health funds are the financial backbone of the Healthcare system. Funds are financed largely through social contributions paid equally by employees and employers and are organised by economic sector, occupational groups and territory. In the course of the case study we shall see how this feature of the German political economy was crucial in the politics of fiscal policy in the aftermath of German reunification. In fact, over time, the funds have repeatedly played the role of political stabilisers. Governments have tended shift the fiscal costs of economic adjustments in hard times to the funds’ independent budgets. This has caused a troublesome increase of social insurance contributions which had to substitute for legislated tax hikes (Manow 2005; Manow and Seils 2000). The federal employment agency administers social insurance around the labour market and governs unemployment insurance and retraining schemes.

## *5.2 PUBLIC SECTOR EMPLOYMENT RELATIONS AND THE SYSTEM OF INTEREST REPRESENTATION*

The “direct” public sector in Germany comprises all employees located at the three governmental levels, the federal, state and municipal. The indirect public sector consists of personnel employed in public law institutions such as the central bank, the social insurance funds and the federal employment agency. This dissertation looks only at the direct public sector.

Public sector employment relations feature a hybrid system characterised by two sets of related regulation (Jacobi, Keller, and Müller-Jentsch 1992). On the one hand, conditions for employees under the status of civil servants (*Beamte*) are of public law nature and determined by special legislation (*Bundesbesoldungsgesetz, BBesG*). On the

other, public employees hired with the status of white- (*Angestellte*) and blue-collar workers (*Arbeiter*) are subjected to private labour law (*Tarifvertragsgesetz*) and enjoy collective bargaining rights similar to those granted to the private sector. The distinction between white and blue collar workers has existed until 2005 when the reform of the collective bargaining system created a new unified professional figure under the status of *Tarifbeschäftigte*. Unions and employers' associations in the public sector negotiate through collective bargaining the terms of employment for the public employees with no special restrictions on industrial conflict.

Keller (1981) has described the two distinct types of employment regulation as the *bargaining model* (regulating public employees) and the *legislation model* (for the *Beamte*). In fact, civil servants' legal status finds its roots in the eighteenth-century Prussian civil service (Kuhlmann and Röber 2004). According to this tradition, the state's professional civil servants enjoy the right to join unions, life-long employment, an adequate salary calibrated on the basis of the constitutionally guaranteed "maintenance principle" (*Alimentationsprinzip*) and generous tax-funded pension provisions managed by a separate social insurance scheme (Federal Ministry of the Interior 2014). Under the maintenance principle, public employers are obliged to provide an adequate remuneration to civil servants, commensurate to the position they occupy. This principle includes disability payments and pension, for which they pay no social contributions. In exchange, they are expected to respect the principles of loyalty, political neutrality, moderation and dedication to the public service. Civil servants are committed to ensure the public interest impartially and are entrusted to secure and safeguard the functions of the public administration. On the basis of this special relationship with the state, they are not allowed to bargain collectively nor to go on strike (Weiss and Schmidt 2008).

Employment and pay conditions for civil servants are set through legislation. The procedure to increase wages is generally initiated after the collective bargaining for public employees has been concluded. The Federal Government submits a draft bill to the parliament for approval. The draft is prepared the Ministry of the Interior and it generally adheres to the terms agreed in collectively bargained contract for the public sector. In the process, the position of the trade unions representing civil servants is communicated to parliaments in the annex of the draft bill. Trade unions do not negotiate but merely exchange their view with the legislators (Federal Ministry of the Interior 2014, 99). The decision to determine the employees' legal status (whether that of civil servant or salaried employee) of newly-hired personnel falls on the employers' side and is arbitrary and often accidental. This has led to a situation in which employees performing similar jobs can have a different legal status most (notably in the education sector), with different economic conditions and legal rights (Keller 1999).

In the past, the legislative power to regulate civil servants' employment conditions and pay had initially been divided between the Federation and the *Länder* depending on the level at which they were employed. Federal civil servants would be regulated by

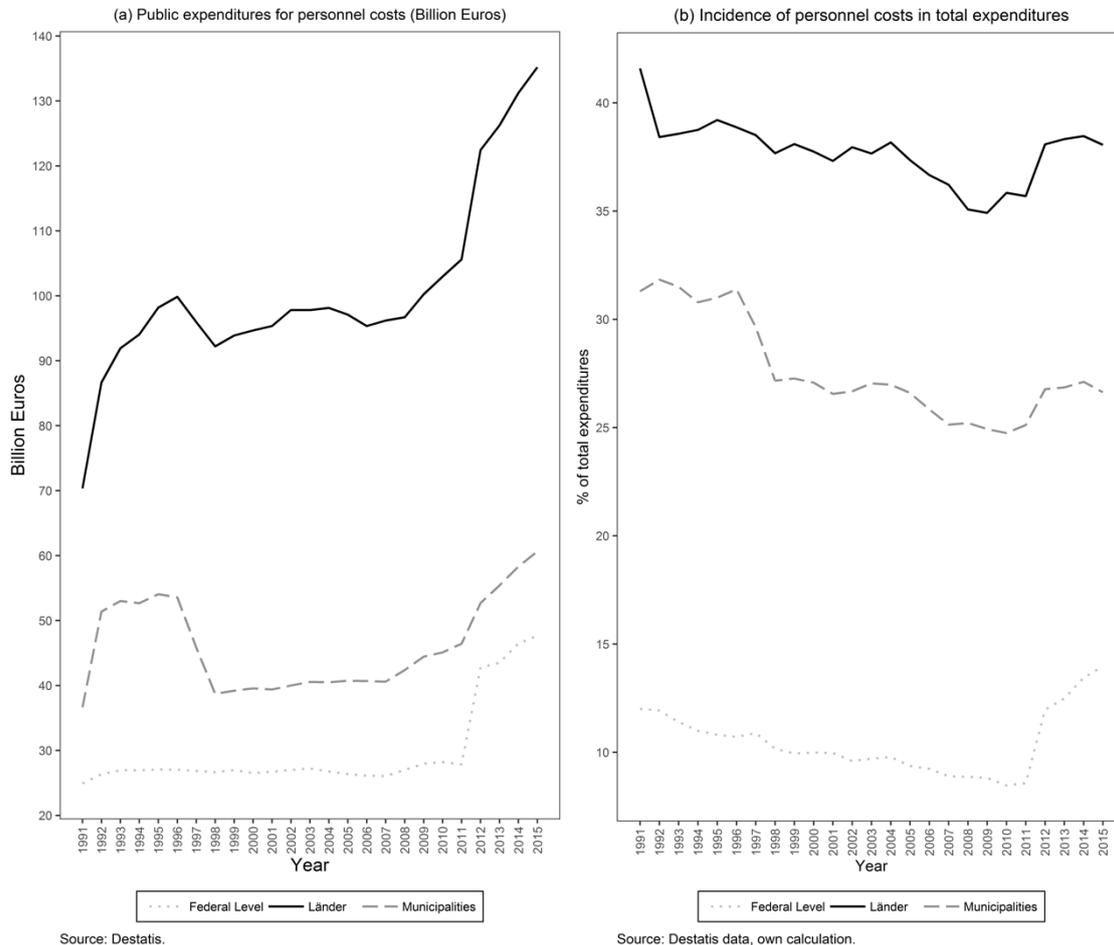
federal law. Civil servants employed at lower levels would instead be regulated by a federal level framework law. The framework law passed by the federal parliament dictated only general guidelines whose legislative details needed to be completed by the Land legislator. This granted States some leeway and enabled some differentiation in civil servants' economic treatment. In 1971 the Basic Law was amended in order to have the federal government legislate on employment and pay conditions of all civil servants across all levels of government. This centralised regulation of civil servants' employment conditions in the hands of the federal legislator. The reform occurred with the approval of the Länder in the Bundesrat. The States gave their consent because centralisation would have helped them to homogenise conditions in the public service across the country. They were strongly interested in reducing the salary competition which had emerged across States notwithstanding the little leeway that the civil service framework law of 1957 granted to Länder legislators (Gunlicks 2003, 123). In the course of the case we shall see how the *status quo ante* 1971 will be re-established through a reform of the German constitution driven by the richer German Länder. The federalism reform passed in 2006 redesigned the distribution of legislative powers. In the event, the Länder asked and (re)obtained the sole competence on setting the remuneration, pensions provisions and career structures of their civil servants (Benz and Sonnicksen 2017, 145).

The distribution of public employment within the state's governmental levels is significantly shaped by the clear division of powers between the Federation and the subnational levels. In the latter, the high shares of public employment depend on the fact that the administration of most of the labour intensive services are constitutionally assigned to the Länder and the municipalities (Bosch et al. 2012). This has relevant financial implications. Figure 11 (panel a) shows the asymmetric distribution of public employment within the three levels of the German public administration. As a result of this asymmetry, the Länder spend around 40% to 35% of their total expenditures on personnel costs, the municipalities around 30% to 25%, while the Federation spends only less than 10% on personnel costs (figure 10, panel b). In the course of the case study, we shall see how this asymmetry will play a crucial role in the political misalignment between the Länder and the two other levels of government in the early 2000s.

Employment levels in the German public sector went down dramatically through the 1990s. The downsizing slowed down during the 2000s and since the crisis the public sector is being slowly expanded (figure 11). It was mostly employment of public employees which went down drastically, especially at the municipal level. Employment of both civil servants and public employees increased instead in the indirect public sector (social insurance funds, federal employment agency, etc.). Atypical forms of employment have become widespread also in the public sector over time (Keller and Seifert 2015). As with the civil servants, they generally do not occupy merely position in core state activities (e.g. police, army, ministries), but are employed widely in other

sectors, most notably the education sector. After the privatisation of the German railway system and the postal system, from the mid-1990s onwards, employment in the German civil service remained rather stable (figure 11 panel b).

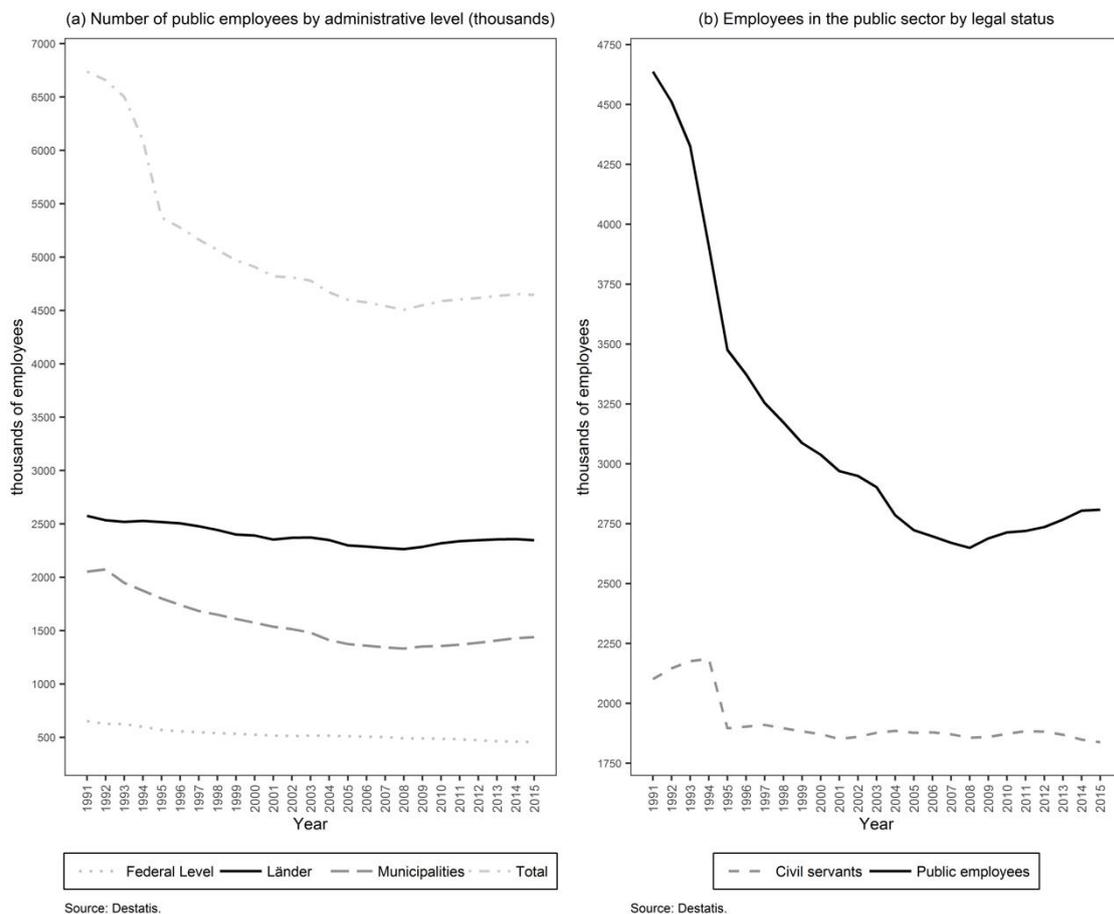
Figure 10: Distribution of personnel costs across the levels of the German public administration



Both civil servants and public employees have the right to organise collectively. The structure of trade union representation in the public sector does not follow the principle of industrial unionism like in the private sector. Until 2001, when the creation of the United Services Union (Ver.di) redefined the trade unions landscape, various independent professional organisations represented different groups of public sector workers on the basis of status or ideology. Similar to the private sector, employment relations in the public sector are based on a dual structure. This includes interest representation through staff councils at the establishment level. Collective bargaining and industrial action on the other hand occur at the sectoral level under the aegis of trade unions and employers' association. Possible disputes between the parts can be subjected to a process of external mediation by a third party, whose results, however, are not binding.

The Public Services, Transport and Communication Union (*Gewerkschaft öffentliche Dienste, Transport und Verkehr, ÖTV*) was the dominant public sector trade union and, with approximately 2 million members in the early 1990s, was the second largest German union after IG Metall. ÖTV represented service sector workers beyond the public services, but its focus was predominantly on the public sector whose employees constituted 90% of its membership (Keller 1999). The other unions were much smaller. The Union of German Railway Employees (*GdED*) and the German Postal Union (DPG) were hardly hit by the privatisation of the railway and postal services during the 1990s. The Union for Education and Science (*GEW*) and the Police Union (*GdP*) had a membership ranging from approximately 300.000 and 200.000 members respectively. All of these organisations were part of the German Trade Union Federation (*Deutscher Gewerkschaftsbund, DGB*), the predominant umbrella organisation of the German trade unions. The German Union of Salaried Employees (*Deutsche Angestelltengewerkschaft, DAG*) instead became an independent union and decided to remain outside the DGB since 1949. It organised around 500.000 public employees. The German Civil Servants' Association (*Deutscher Beamtenbund, dbb*), a peak level confederation acting parallel to the DGB, includes more than fifty unions representing around 1.1 million members, mostly although not only with the status of Beamte.

Figure 11: Public sector employment in Germany, total and by administrative level (1991-2015)



Due to a loss of membership throughout the 1990s and decreasing organisational strength, in spring 2001 five service sector unions merged into the United Services Union (*Ver.di*) (the process is described in sub-section 5.3). The German Postal Union (DPG), the Commerce, Banking and Insurance Union (HBV), the Media Industry Union (*IG Medien*), ÖTV and the DAG merged into what became the largest trade union in any industrialised country (Keller 2005b).

Trade unions represent public employees in the regulation of employment relations through collective bargaining with the public employers. Beamte do not have the right to bargain collectively but the protection of their interests during the legislative process determining employment relations is ensured through their associations' (dbb and DGB) lobbying and networking activities (Schmidt and Müller 2018). Civil servants' representative organisations have established ties in the political arena and, in procedural terms, have gained the right to hold consultations with the Ministry of the Interior twice a year (Keller 2010, 127).

The German public employers are organised around the three main administrative levels of the federal state (Keller 2011). There are no independent agencies representing the government in employment relations in Germany. At the federal level, the Minister of the Interior - in coordination with the Finance Minister - is the figure responsible for the regulation of employment conditions and for drafting pay legislation for civil servants. At the Länder level, States' interests are represented by the bargaining association of the Länder (*Tarifgemeinschaft deutscher Länder, TdL*), to which States generally send their Finance Ministers. At the local level an umbrella organisation (*Vereinigung der kommunalen Arbeitgeberverbände, VKA*) groups together the different employers' association (*Kommunalen Arbeitgeberverbände, KVA*) present in each state.

Until the overhaul of the wage bargaining system in 2005, collective bargaining in the public sector has been centralised and encompassing. Bargaining has been the sole mode of pay determination for public employees covering all the three administrative levels and all the trade unions. Wages and employment conditions were generally settled jointly during yearly rounds of negotiations between the unions and the employers. Prior to the reform, most of public employees were regulated by three main collective contracts (Dribbusch and Schulten 2007, 159): the Federal Collective Agreement for white-collar workers (*BAT*), the Federal Collective Agreement for blue-collar workers (*MTArb*) and the Federal Collective Agreement for blue-collar workers at the local level (*BMT G II*).

On the unions' side, ÖTV used to be the dominant actor in negotiations and coordinated requests from the smaller unions. Until 1976, the ÖTV bargained jointly with the public sector wing of the white collars' union DAG (outside of the DGB) but differences over pay structures led the ÖTV to end the arrangement (Markovits and Silvia 1992, 178). On the employers' side, TdL and VKA were part of a bargaining

coalition (*Tarifgemeinschaft*) in which the three employers bargained jointly under the leadership of the Minister of the Interior. The employers' bargaining coalition had meant to reach a single national collective agreement in order to avoid differences in the public sector. Until the reform, the unions' bargaining cooperation (led by ÖTV) and the public employers' bargaining coalition (led by the Federal Minister of the Interior) ensured the centralisation of wage bargaining in the public sector. This has led to great homogeneity of pay and employment conditions in public services across the country (Keller 1999).

### 5.3 THE FISCAL CONSTITUTION OF THE STATE

Most of the taxes in Germany are collected by the States who act as administrative agents for the Federation. A system of both separate (*Trennsystem*) and joint (*Verbundsystem*) taxes co-exists. Under the system of separate apportionment of revenues, each governmental tier appropriates the revenues from specified taxes. For instance, the Federation enjoys the yields of fiscal monopolies and other taxes (e.g. custom duties, road freight, some excise taxes, etc.). The States collect own revenues from inheritance tax, bee duties and taxes on motor vehicles while municipalities collect revenues from trade tax and real property tax. These are however minor taxes. The major taxes, which together form more than 80% of total revenues (Buettner 2006, 217), are subjected to the regime of shared apportionment (joint taxation) among the three governmental levels. These are the personal and corporate income taxes and the VAT. The Basic Law legally restricts federal and Länder borrowing only to investment spending, while borrowing at the local level is allowed only for cash-flow reasons and is subject to Länder's control (Spahn and Föttinger 1997).

Germany disposes of an intricate system<sup>20</sup> of vertical redistribution among the administrative units of the Federation (*vertikaler Finanzausgleich*) and horizontally across the Länder (*horizontaler Finanzausgleich*). The system, constituted of five stages of fiscal equalisation, is meant to equalise each state's per capita governmental revenues in order to allow the States to preserve the "equivalency of living conditions" (art. 72(2) Basic Law) across the country. In the first stage, both separate and joint taxes are vertically redistributed from the Federation to the Länder in order to provide the primary resources to carry out their administrative responsibilities. In stage two and three, joint tax revenues are redistributed horizontally across the States. Personal and corporate income taxes are distributed according to the residency principle (*örtliches Aufkommen*) while 75% of the Land share of the VAT is distributed on a population basis. Subsequently, in stage three, the remaining 25% of VAT revenues is distributed from more affluent States to poorer ones in order to lift their per capita revenues up to 92% of the average of all Länder. In stage four resources are redistributed from rich to

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<sup>20</sup> A thorough technical analysis of the system is beyond the scope of this dissertation. A good overview is given by Gunlicks (2000), Gunlicks (2003, Ch.5) and the Federal Ministry of Finance (2009).

poor States on the basis of their fiscal needs. States whose fiscal capacity exceeds their fiscal needs redistribute resources to poorer States so as to bring their fiscal capacity up to 95% of the average. In stage five, federal supplementary grants are given to the poorer States so that their fiscal capacity reaches 99.5% of the average.

The salient trait of this complicated system is that, despite the federal system of the country, *the tax system is highly centralised*, creating cleavages and political tensions. In fact, the system creates an asymmetry between the Federation and subnational governments, making the latter structurally dependent on the former. For instance, in 2014 the Federal government collected about 42% of all tax revenues while being responsible only for about 28% of all public expenditures. On the contrary, States and local communities' expenditures constantly outpace their revenues, making them reliant on the federal government to cover the difference (Langenbacher and Conrads 2017, 322).

The German fiscal constitution (*Finanzverfassung*) is thus characterised by two sorts of tensions. On the one hand, the Basic Law requires the Länder to sustain a unitary welfare state in order to avoid regional disparities across the country and ensure "nation-wide expectations of fairness and equality" (Gunlicks 2003, 163). On the other, it ensures that the Länder remain autonomous and independent of each other and of the Federation as far as the management of their budgets is concerned (art. 109(1) Basic Law). The second source of tension stems from the *centralisation of tax legislation* at the federal level and the *decentralisation of administrative tasks* to subnational governments. This is a core peculiarity of the German fiscal federalism system.

Concerning the first source of tension, given large disparities in States' economic development and thus tax capacity, a system of intergovernmental transfers is needed to redistribute revenues and enable States to meet the constitutional principle of "equivalency of living conditions" across the country. With regard to the second, the result is that the complex architecture of the German fiscal constitution structurally constrains the fiscal autonomy of the Länder. States do not dispose of the autonomous legal capacity to manipulate revenue arrangements at will. In fact, while they bear most of the burden of administrative responsibilities, each Land taken alone has virtually no influence over federal tax legislation. This specificity puts enormous pressures on the Länder and the municipalities to rein in expenditures given the lack of fiscal autonomy on the revenues side.

Financial arrangements are defined by the Basic Law. Lack of fiscal autonomy stems from the fact that major revisions of tax legislation require a constitutional change which can be implemented only through a two-thirds majority in both chambers of the federal parliament (Spahn and Föttinger 1997). This implies that nearly all significant changes to the tax regime necessitate a broad consensus, if not unanimous agreement, between the governing majority at the federal level and the governments of the Länder. However, this system of "joint decision-making" can morph into a "joint-decision trap"

when Länder governments control a hostile political majority in the upper chamber (Scharpf 2005). In hard-core financial issues, States' prime ministers naturally tend to prioritise the Land interest over party loyalty when voting in the Bundesrat. This means that asymmetric interests between poor and rich States further increase the rigidity of the system and diminish the likelihood of compromised reforms. The situation has grown ever more problematic after reunification has considerably increased the disparity between rich and the poor States of Eastern Germany.

Gunlicks (2003, 164) provides an apt depiction of the system, useful to understand how the different tiers interlock with each other:

*“the federal government does not control the tax system, but the Federation does. ... (T)he government and its majority in the Bundestag can pass legislation that also binds the Länder, but the Bundesrat, which represents the Land governments, must approve such legislation as long as the tax revenues accrue at least partially to the Land or local governments. The result is that the Länder ... have about as much power collectively as the federal government and its majority in the Bundestag in passing finance legislation, but the individual Länder, especially if they are in the minority, have little influence. The Land parliaments, which are not represented in the Bundesrat, have even less to say.”*

Given the interlock of the Bundestag's veto power within a system of shared taxes and fiscal equalisation among unequal States, a two-dimensional conflict line exists in the system of public finance in Germany. The centralisation of tax powers at the federal level has left the States with no fiscal autonomy and the municipalities with very little autonomy (on property and business taxes). This produces a “vertical” cleavage between the Federation (whose taxing powers have grown over time) and the Länder, whose expenditures are predominantly funded by centrally regulated taxes (and grants) over which they exercise no control except for the collective action in the Bundesrat. In the latter, however, consensus-based decisions are hampered by a “horizontal” cleavage between rich and poor States, who can outvote them. The situation leaves everyone unsatisfied (Gunlicks 2003, 190-99). Richer States (i.e. Bavaria, Baden-Württemberg, Hamburg and Hessen) would like to retain a larger share of tax revenues on their territory and break free from the costly system of fiscal equalisation (in which they are net contributors) in order to obtain fiscal autonomy. This would introduce a system of competitive federalism. The overhaul of the system however is blocked by the veto power of poorer Länder who depend structurally on the fiscal equalisation system to continue ensure the equivalence of living conditions across the countries.

Needless to say, the poor States fear losing intergovernmental revenues: with a reform of the equalisation system their spending capacity would be curtailed further. Given economic disparities and structural factors beyond their control, poor States would be net losers in a system of competitive federalism. In the course of the case study we shall see how these features of the German system of fiscal federalism have had crucial implications for the constitution of the new institutional equilibrium in public sector wage setting.

#### 5.4 LEGAL AND FISCAL WATCHDOGS

German law has the character of codified law influenced by the tradition of Roman legal codes and the Napoleonic code. This means that there exists a written legal system with no judge-made laws, like in the Anglo-American common law systems. Judicial review, i.e. the authority of highest courts to nullify legislative or executive acts on constitutional grounds, was included in the Basic Law in line with the desire to check and balance governmental authority. An administratively independent and financially autonomous Constitutional Court was set up in 1951 charged with the functions of judicial review, the adjudication of disputes between States and federal institutions, the protection of individual rights and the safeguarding of the constitutional and democratic order (Langenbacher and Conradt 2017, 293).

Similarly, government auditing is provided in Germany by the Federal Court of Audit (*Bundesrechnungshof*) and each Land's auditing Court (*Landesrechnungshöfe*). The court is charged with the task of "auditing the account and examine the performance, regularity and compliance of financial management" of all financial operations and transactions of the federal and States' governments (Von Wedel 2005). Yet their mandate is limited to recommendations and their function is not a judicial one. Hence, their decisions and suggestions are not binding.

The German Bundesbank constitutes a fundamental centre of power within the German political economy. The Bundesbank served as the central bank of the country until the ECB took over the responsibility for the conduct of monetary policy in 1999. The Bundesbank is legally independent from the federal government, the Länder and, differently from other para-public institutions, also from socio-economic organised interests. The Bundesbank is not accountable to the parliament and it has been generally seen as one of the most independent and conservative (inflation-averse) central bank in the world. Frequent have been the contrasts between the Central Bank, the government and social partners around the Bundesbank's assertive anti-inflationary behaviour. According to its constitution, the Bundesbank is obliged to support the government's economic policy only to the extent to which accommodation does not conflict with the bank's primary objective of safeguarding the currency (Langenbacher and Conradt 2017, 285-86). These conflicts have often put it in a structural position to successfully impose on the social partners the conduct of moderate fiscal and wage policies under the threat of severe monetary tightening (Marsh 1992). Thus through the legal capacity to control monetary policy independently, the Bundesbank could use its power to severely affect or even impose U-turns in both fiscal and wage policies. This dynamic is famously demonstrated by the example of the 1973-1974 critical juncture when the bank completed its turn toward monetarism. In the event, the Bundesbank tightened monetary policy to punish the loss of wage discipline (hence of fiscal discipline too) by the public sector trade union ÖTV which had managed to extract a 12% wage increase during the 1974 bargaining round (Scharpf 1991, 128-39).

## CHAPTER 6. THE 1990s. DIE BLÜHENDEN LANDSCHAFTEN HIT THE VINCOLO ESTERNO

This chapter takes the reader through a historical analytical reconstruction of public sector wage setting in Germany during the 1990s. In Sub-section 6.1 the aftermath of reunification is analysed as a period in which both fiscal and wage discipline were lost. This triggered the reaction of the Bundesbank which, by tightening monetary policy, induced a U-turn in both fiscal and wage policy. Sub-section 6.2 thus covers the period 1994-1997 in which public sector wage restraint began in relation to the public employers' necessity to pursue a policy of fiscal consolidation. Lastly, sub-section 6.3 provides a critical analysis of the historical reconstruction in light of the alternative explanations derived from the literature review.

### *6.1 REUNIFICATION AND THE LOSS OF FISCAL AND WAGE DISCIPLINE (1990-1993)*

In Germany, the 1980s was a decade of steady but not drastic fiscal consolidation. After a coalition between the Christian Democratic Union (CDU) and the Free Democratic Party (FDP) took power in 1982, a trajectory of moderate fiscal austerity was sold to the electorate as an exercise in “social balance” and as a necessity to revive the “social market economy” (Zohlnhöfer 2007, 1128-29). Consolidation was pursued regardless of the SPD-led opposition which, while being in disagreement, did not have a majority in the Bundesrat to obstruct it. In 1984, a savings package (*Sparpaket*) was implemented to continue the trajectory of fiscal consolidation and avoid undermining business confidence. Deficit reduction was achieved entirely through spending cuts. Of the entire amount of spending cuts (11.8bn DM or 0.6% GDP), more than half of the savings were obtained through legislated cuts on civil servants' salaries and unemployment benefits, which were reduced from 68 to 63% of net earnings (Devries et al. 2011, 39).

After the civil service had paid its toll to ensure the consolidation of German finances, the 1980s developed fairly smoothly. When reunification approached, Germany was in a relatively good fiscal shape. On 9 November 1989, the Berlin Wall fell and conjointly the GDR's borders with West Germany were opened. Millions of East Germans flocked to the Bonn Republic, asking for freedom and prosperity. The Socialist Unity Party, which had maintained a forty-year monopoly of power in the GDR, had begun to crumble. In an attempt to seize control of the process, the CDU Chancellor Helmut Kohl presented before the Bundestag a ten-point program aimed at gradually unifying the two States over the course of the following decade. Yet history moved faster. Deteriorating economic conditions and the incoming of Eastern Germans into the West accelerated the necessity to anticipate elections in the GDR to mid-March 1990. A pro-unification grand coalition of CDU, Liberals and SPD took power with the mandate to

guide the assimilation process of the GDR into the Federal Republic of Germany. On 1 July 1990, the First State Treaty entered into force which set the terms for the Currency, Economic and Social Union. The East German economy was on the brink of collapse. The Deutschemark, together with the FRG's welfare and social provisions of the Social Market Economy, were introduced wholesale in the East. Eventually, political unification was achieved on the condition that elections would be immediately held in the new unified Germany. On 3 October 1990 Germany was reunified and the GDR became "nothing but a footnote in world history"<sup>21</sup> (Paterson and Smith 1992).

On the day of currency unification, during a televised speech addressed to his fellow Germans, Chancellor Kohl had pledged to turn the new Länder into blossoming landscapes (*Blühende Landschaften*) through a joint effort to equalise Eastern Germany's living conditions on a par with those in the West. Over the process, he pledged, "no one will have to do without anything", "No one will be worse off than before", "and many will be better off". The first general elections in the reunified Germany were held in December 1990 and, thanks to the determined stewardship of the unification process, resulted in an overwhelming success for Kohl. A CDU/CSU/FDP coalition government was subsequently formed under the assumption that the costs of reunification would be met mostly thanks to budget cuts and increasing tax receipts as a result of an economic boom (Poguntke 1992). Further revenues would ensue from the privatisation of Eastern Germany's companies entrusted to the newly created *Treuhand* agency<sup>22</sup>.

Public policy in the immediate aftermath of reunification was driven by the objectives of minimizing social conflict and ensuring a rapid and smooth convergence between the East and the West. The herculean task the government was confronted with was that of integrating a command economy into a capitalist market economy. For the purpose, a "big bang" approach was eventually adopted. The hope was that the shock to which Eastern Germany was about to be exposed to would be mitigated by the institutional and financial support of Western Germany. The entry into force of the currency, economic and social union meant that, as of July 1990, property rights were reintroduced in Eastern Germany and a regime of tariff-free internal trade was adopted. Monetary unification brought the D-Mark to the East. Against the will of the Bundesbank, a political decision was taken to convert wages, salaries and other recurring payments at a par, while the conversion of assets and liabilities into the new currency was set at 2:1. West Germany's regulations on competition, corporate and social issues were extended to the new States. These included a common legal

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<sup>21</sup> This quote is attributed to the German writer Stefan Heym.

<sup>22</sup> The Treuhandanstalt was a public agency owned by the Federation which was set up on 1 March 1990. It took over, as an institutional trustee, the nationalised economy of Eastern Germany with the purpose of managing the dismissal of the Eastern companies through privatisations. At the end of 1994 the agency's operations were terminated. The agency closed with DM270bn of debt which, as of 1 January 1995 has been taken over by the Federal budget. For a more detailed analysis see (Czada 2000).

framework for the institutions and the regulation of the labour market and collective bargaining. In the process of institutional transfer, the unions of the DGB had agreed to resort to the Western jurisdiction in case of controversies on unions' reorganisations. Yet they also orchestrated the dissolution of their Eastern counterparts to then recruit members from the East within their ranks. Only IG Chemie merged with its Eastern sister (Markovits and Silvia 1992, 173). To facilitate adjustment in the Eastern labour market, early retirement benefits were granted to workers over the age of 55 and the civil servants which became redundant in the course of administrative reorganisation were put on a waiting list, pending future replacement (OECD 1991, 36).

As it turned out, the economic boom on which political promises and economic projections were based occurred only partially and disparities widened between the West and the East. While the expansion of fixed investments and private consumption generated faster growth and declining unemployment in the West, throughout 1990 and 1991 different factors brought the Eastern economy to its knees. The sudden full exposure to international market competition, on a par with strong socio-political pressures for wage convergence to the Western levels, led to the collapse of a structurally-weak industry in Eastern Germany. The collapse of the COMECON common market reduced Eastern German exports to Eastern Europe and the USSR, while the old goods of the GDR were being repudiated at home as a sign of a breach with the past. As a result, industrial production fell abruptly over the course of 1990 (with peaks of output losses of 70% in the metalworking sector) and unemployment skyrocketed (OECD 1991).

Economic hardship in the East scaled up the challenge of financing reunification and support incomes and living standards in the new States. In line with election promises, no major taxes were initially announced to finance reunification. For the major part, this meant that, throughout the process, the government strategically shifted the financial burden onto the German contribution-based welfare state. Social security levies and higher telephone charges served as functional equivalence to increase revenues for the federal budget (Poguntke 1992). In fact, given that Germany's social insurance schemes enjoy fiscal autonomy and are financed out of contributions levied on wages, the government avoided introducing major taxes. It instead raised unemployment insurance contributions by 2.5% in 1991 and exploited the health insurance and pension schemes to indirectly cover parts of the ensuing social expenditures for the East (Manow and Seils 2000). Over the course of 1991 it became clear that higher pressures on spending had to be met with higher taxation. The government provided support to strengthen investments in the East through a package of subsidies named "Upswing East", some fuel and energy taxes were increased and a 7.5% solidarity surcharge on income and corporation tax was introduced.

For the other part, until 1993 when the first effort to retrench was pursued, in the aftermath of reunification the government tolerated sharp increases in budget deficits (Zohlnhöfer 2007, 1130). The costs for the budgets of the old States were modest while

the Federation footed the bulk of the reunification bill. The German Unity Fund was created to finance the deficits of the new Länder until 1995 when they would eventually join the Western Germany's fiscal equalisation scheme. Allowing from the beginning the new States into the system would have meant an increase in horizontal transfers to the poor Eastern Länder from DM3.5 billion in 1989 to DM 20 billion. This would have made all the old Länder but Bremen and Saarland net contributors to the system (OECD 1993, 88-89). Before unification in 1990, the West German States had therefore exploited their veto in the Bundesrat to block the extension of the equalisation scheme to the Eastern States. Furthermore, in the context of negotiations for a "solidarity pact" in 1992, the reform of the fiscal equalisation scheme was negotiated between the federal government and the States in order to incorporate the new East German States. The Länder united managed to extract an increase in the States' share of VAT revenues from 37 to 45% to finance new transfers to the East (Sally and Webber 1994).

Next to the loss of fiscal discipline necessary to subsidise the East, the loss of wage moderation contributed further to inflate the economy. The wage agreements which were conducted in the second half of 1990 led to substantial increases in basic wages, improvements in working condition and clauses to protect or compensate redundant employees against dismissals. Wage agreements in the metal and electrical industries became the pilot agreements to equalise gradually, despite remarkable productivity differentials, Eastern wages to Western levels by 1994 (D. Goodhart 1991). Wage equalisation was welcomed by both unions and employers in order to sedate east-to-west labour migration and avoid wage dumping. Overall, in 1990 wage increases throughout the economy averaged 6% and agreements in the metalworking sector also envisaged special reductions in working hours (OECD 1991, 51-54).

To punish the government and the wage setters for their lack of moderation (Lange and Pugh 1998, 168-69) and to snap off an intensifying cost-price spiral which had become clear by summer 1991 (Fisher 1991b), the Bundesbank raised its *Discount rate* and *Lombard rate* to unprecedented levels.<sup>23</sup> By pursuing a policy of extraordinarily tight money, which lasted for a prolonged span of time, the Bundesbank imposed on the wage setters the necessity to moderate their claims and, on the fiscal authorities, the pursuit of a strict policy of fiscal consolidation at any price (Jörg Bibow 2003). In the meantime, in December 1992, the German Parliament approved the ratification of the Maastricht treaty which set the German political economy on its "Road to the EMU". This meant that the criteria of sound public finances and price stability had to be met at last by 1999, with the first verification test being the 1997 fiscal year.

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<sup>23</sup> The discount rate was increased from 6% on November 2<sup>nd</sup> 1990 up to its peak of 8.75% on July 17<sup>th</sup> 1992. The Lombard rate was increased from 8.5% to 9.75% during the same time span (Bundesbank, Interest rates statistics).

1991

While the other contracts in the private sector were being negotiated throughout 1990, public sector wages were still regulated by the previous contract which envisaged a 1.7% increase due to terminate by the end of the year. Trade unions' requests for the 1991 public sector contract were advanced in the second-half of November 1990, when ÖTV claimed a pay increase of 10% for 4.6m employees in the public sector (Marsh 1990). The demands were openly against the recommendations of the Bundesbank which had suggested a corridor in between 1% to 2% due to budgetary and inflationary concerns (Fisher 1990).

The December 1990 elections led to the formation, in January 1991, of a Christian-liberal coalition government which, however, at the Hessen land election on January 20<sup>th</sup> immediately lost its majority in the Bundesrat in favour of the SPD-led opposition. Negotiations between the employers and the unions took place in March with the employers offering a 4.2% rise, highlighting the difficulty of the budgetary situation. Against this, ÖTV called for a one-day warning strike claiming that public employees had not experienced real wage increases since 1975 and that public sector pay was lagging behind that in the private sector by 16.5% (D. Goodhart 1991). Amidst expectations by economic commentators of a pay settlement around 5%, negotiations were concluded quickly in the second half of March with the government conceding a 6% pay increase. With the agreement, the legal framework for collective bargaining in the public sector was extended to the Eastern German public sector with Eastern wages starting at a 60% level of those in the West. Similar provisions were then extended to the civil servants via legislation (*Bundesbesoldungsgesetz*) effected in February 1991 but valid retroactively from March 1<sup>st</sup> 1991, thus two months in delay with regard to the entry into effect of the collective bargaining contract.

1992

The autumn of 1991 was presented in the economic press as the “autumn of discontent” (Peel 1991a). Indeed, the ensuing wage-price spiral had become clear during the summer when inflation reached a peak of 4.3% in the populous state of North Rhine-Westphalia (Fisher 1991b). By the end of 1991 the cost of living index was rising at a 21% pace in Eastern Germany in the face of an unemployment rate of around 15% (OECD 1992, 56). The Bundesbank raised interest rates in mid-August 1991 right in advance of exploratory meetings between the engineering employers and the IG Metall. This was intended to send a strong signal that the Bank would no longer tolerate further “irresponsible” pay settlements like those which were hitherto averaging around 7% (Fisher 1991a). The 1992 “hot” negotiating cycle took place against the background of steepening “home-made” inflationary pressures and the collapse of output and employment in Eastern Germany.

Ignoring appeals for moderation from the government, the Bundesbank and the employers, in late October 1991, IG Metall staged a request for a 10% wage increase (Parkes 1991) and ÖTV followed suit advancing a 9.5%. On 20 December the Bundesbank again raised both the discount rate from 7.5 to 8% and the Lombard rate from 9.25% to 9.75% as a direct attack on the wage negotiations rounds. Trade unions reacted furiously to what they perceived as an unjustified interference in the wage bargaining process to the point that Monika Wulf-Mathies, the leader of ÖTV, accused the Bundesbank of acting as “an agency of war” (Peel 1991b).

During his end of the year speech, Kohl urged the trade unions to lower their wage claims but, in early January, tensions emerged within the government when the FDP economics minister Jürgen Möllemann advanced a proposal to impose a statutory pay limit of 5% on the civil servants. In order to send a signal to the private sector and to influence wage negotiations for the public employees, the German government, he argued, “should use its legislative powers to limit civil service pay rises ... to less than 5%” (Parkes 1992b). In reaching beyond his ministry’s competence, the economics minister had intended to turn the logic of the public sector negotiations on its head. In fact, the usual procedure envisaged that, after a wage agreement for the public employees was reached with the trade unions, similar provisions would subsequently be adopted through legislation and applied to the civil servants. This procedure has been in the interest of both parts to avoid tensions between two distinct legal spheres within the public workforce. Möllemann intended to reverse the procedure and, by imposing an *ex ante* statutory wage ceiling on the civil servants, he hoped to force restraint upon the public sector settlement with ÖTV. Needless to say, the dbb, the DGB and all the other unions involved rebuked the proposal, denouncing it as an undue interference in free collective bargaining (EIRR January 1992). Upon the proposal, contrasts emerged between the economics and interior ministries, respectively under FDP and CDU leadership. The CDU Interior Minister Rudolf Seiters firmly rejected Möllemann’s proposal and publicly attacked him for interfering in matters of public sector pay, a prerogative of the Interior Ministry. While both Möllemann and the FDP chairman Otto Lambsdorff defended the proposal to act unilaterally as “a remarkable solution for a remarkable situation”, Seiters (flanked by the DGB the ÖTV and IG Metall) dismissed them arguing that in matters of civil servants’ pay determination “public suggestions from the economics minister are neither appropriate nor helpful” (Parkes 1992a).

On behalf of the federal, state and local authorities, the Interior Minister Seiters tabled a pay offer of 3.5%. The offer was deemed unacceptable by the unions which were asking for a 9.5%. The government was unwilling to compromise and modify the offer because it wanted to impose a turnaround in the trend of excessively generous pay settlements. When talks collapsed in March, after four unsuccessful rounds of negotiations, ÖTV’s plan to call an immediate ballot to go on strike was neutralised by the employers’ call for arbitration (Peel 1992a). Arbitration imposes a six-week peace

period. Thus, in early April the arbitrators advanced a non-binding proposal for a 5.4% increase which both parts rejected (Parkes 1992c). Among the employers especially, a consensus emerged around a maximum final offer which should be not higher than 4.8%. ÖTV found it unacceptable.

As a result, both unions in the public sector cast internal ballots to launch strike action. After positive results in the internal ballots, the DAG the DPG the ÖTV and other smaller unions launched a full-scale strike which disrupted public services throughout Western Germany. Up to 330.000 public workers were mobilised, bringing chaos to road, railways, airports, postal and refuse collection services in what became one of the most disruptive public sector strike in the history of Germany (Keller 2017). Rather than a simple strike, the union's move was a political action which enjoyed widespread public sympathy (EIRR May 1992). The unions were attacking principally the government's proposal to pay for unification by imposing public sector wage restraint on the one hand and legislate tax increases which burdened wage earners on the other (Markovits and Silvia 1992, 182).

Public employers were somehow split on whether to give up to unions' claims. The SPD Finance Minister of Schleswig-Holstein, Heide Simonis, was signalling the desire on behalf of the Länder to reach a compromise beyond the 4.8%. The Interior Minister Seiters opposed any further improvement (Peel 1992c). Eventually, after eleven consecutive days, in early May, ÖTV achieved a pay settlement of 5.4% (including 200DM extra holiday pay and extra lump-sums for the lower paid) in line with the arbitrators' proposal which the employers had previously rejected. A compromised solution was favoured by the employers of the Länder who had signalled their intention to put an end to the unions' disruptive strike actions.

While the settlement was welcomed by all the other public sector trade unions, the grass roots of ÖTV, unsatisfied with the results after prolonged mobilisation, issued a formal complaint. This forced the union leaders to cast an internal ballot on the agreement's result which eventually did not obtain a majority. As a result, the week after the victorious public sector settlement, ÖTV leader Monica Wulf-Mathies was asked to resign. At the same time, the Interior Minister Seiters ruled out any possibility to reopen negotiations for further improvements (Peel 1992b). The ÖTV leader refused the resign and called upon ÖTV's members to show a "greater degree of political and economic realism" for what had been a successful bargaining round for the public sector (EIRR July 1992). The situation was resolved after the "pilot agreement" in the metalworking sector was signed on May 18<sup>th</sup>. This came to her rescue and helped to resolve the intestine conflict within the ÖTV. Of help to Mrs Wulf-Mathies was the fact that the powerful IG Metall too had to back down from initial demands of 9.5%. Against the metalworking employers which had offered a mere 3.3%, the IG Metall's union leadership could point at the generous public sector settlement. This forced the employers to push up their initial offer. Eventually, to avoid industrial action metalworking unions and employers settled on a compromise crafted around the 5.4%

obtained in early May in the public sector (EIRR June 1992). Thus, the ÖTV bargaining commission argued that a better result could not be achieved with a renewed industrial action and refused to reopen negotiations in accordance with their internal statute.

Similar provisions to those bargained collectively for the public employees were then transferred through legislation effected in March 1993 to the civil servants.

### *1993*

With a fall in demand and output throughout 1992 and the beginning of 1993 (OECD 1994), Germany had started to endure the recessionary effects of the Bundesbank's monetary tightening. In December 1992 ÖTV advanced its requests for the 1993 bargaining season. While Monica Wulf-Mathies acknowledged the country's economic stagnation, she renewed her intention not to tolerate losses in workers' real incomes. In fact, in early 1992 the government had managed to push through the Bundesrat an increase in the VAT tax with the support of the SPD-led Brandenburg government (Sally and Webber 1994, 24). With an inflation rate at 4%, ÖTV's chair advanced a pay claim of 5% with a minimum increase of 150DM to favour lower income groups and reduction in the 38.5 weekly working hours. Furthermore, ÖTV firmly rejected the public employers' proposal to slow down wage equalisation of Eastern to Western wages, due to rise to 80% as of 1<sup>st</sup> July 1993 (EIRR December 1992).

After three failed negotiating rounds, the public employers, led by the Interior Minister Seiters, made a 3% offer which paved the way to a smooth agreement in early February 1993. As a result of two intense days of bargaining, on 4-5 February, the DAG and ÖTV's negotiators recommended to accept the 3% offer which they regarded as a "responsible" deal, taking into consideration the deteriorating economic climate and the financial burden of reunification (EIRR March 1993). The agreement struck a mid-way between compensating employees for the inflation level without the possibility, however, to take into account the VAT tax hike. Similar provisions as those negotiated for the public employees were extended to the Beamte through legislation effected in December 1993. The entry into force of the pay increase for the civil servants, however, was delayed until May 1<sup>st</sup>, with four months of delay compared to the public employees.

The public sector wage agreement was being closely monitored by the Bundesbank which had publicly recommended a 3.5% as the acceptable upper ceiling (Parkes 1993). As a matter of fact, the moderate agreement paved the way, on the same day, to the Bundesbank gradually reversing its policy of tight monetary. After interest rates had reached historical peaks in mid-September 1992, the agreement between the public employers and the unions made it easier for the central bank to start lowering interest rates (Peel 1993). On the same day in which the public sector wage setters reached an

understanding which was deemed “responsible”, the discount rate was decreased by 0.25% and the Lombard rate by 0.5%.

## *6.2 PUBLIC SECTOR WAGE RESTRAINT IN THE FACE OF BUDGET DEFICITS (1994-1997)*

Throughout 1993 the inflation rate started to slow down thanks to decelerating wage growth and a rebound in productivity rates. After the loss of wage moderation which followed reunification, average wage increases across the private sector went down to 3.5% in 1993 and 2% in 1994 (OECD 1994, 41). At the same time, due to the worsening of public finances, 1993 marked the year in which the government made a turnaround in fiscal policy. The deficit of the general government had breached the 3% threshold in 1993, eliciting a marked policy shift toward fiscal restriction to be achieved through ceilings on expenditures’ growth (OECD 1994, 119). With the economic crisis exacerbating and unemployment on the rise, the government reacted by reintroducing the surcharge tax (to be effective as of beginning of 1995) and by effecting cuts in social spending, particularly unemployment compensation (Zohlnhöfer 2007).

On the political side, 1994 was the “super election year” with Land, European and Bundestag elections taking place throughout the year. While at the Lower Saxony Land election in March it seemed that the SPD and the Greens were on an ascending path, at the June European elections the party suffered a serious setback. The CDU fared better than expected marking a turning point in the run-up to the Bundestag election in October. Kohl’s popularity was on the rise since May onwards and the Christian-liberal coalition eventually remained in power although the FDP was significantly weakened by having lost all seats at all Land elections and at the European election (Poguntke 1995).

### *1994*

The year 1994 began with the Finance Minister Theo Waigel on the offensive. In an editorial on the German economic daily *Handelsblatt*, Waigel reassured the public – especially the Bundesbank – that the government was firmly committed to decreasing the budget deficit by limiting expenditures to 3% of GDP. Hans Tietmeyer, the Bundesbank’s president, had made cuts in social security expenditures (“however painful”) and reducing the deficit a precondition for allowing the relaxation of monetary policy (Dempsey and Waller 1994).

Public employers followed suit. After a first failure, the second round of negotiations ended without an agreement in sight. ÖTV and DAG were demanding a 4% pay to protect workers’ purchasing power against anticipated inflation and indirect tax hikes. The sub-national employers, however, took a confrontational stance. Heinz Scheussler, the Nord Rhein-Westfalen’s Finance Minister representing TdL, came into prominence

during negotiations for advancing a “*zero pay round*” needed to alleviate the severe strains on the public budgets. Indeed, both Länder and municipalities’ employers (led by the Duisburg mayor Richard Klein) started to raise their stake in wage bargaining. TdL proposed to reduce the pay grades in the public sector from 15 to 10 in order to save around 100 million DM per year. Municipal employers instead put forth a list of measures containing more flexible working time, the abolition of 2 holidays introduced in 1985 and a cut in bonuses for part-time employees doing shift work (EIRR March 1994).

Against the serious threat of a zero round and an employers’ “shopping list”, ÖTV and DAG opted for a concessionary bargain after acrimonious negotiations accompanied by warning strikes. The parts agreed on a 2% increase which however contained other pejorative aspects for the workers. First of all the contract was not retroactive to January 1994, thus granting to the employers several “improvements-free” months. Different provisions for different pay groups were made. For lower groups the contract would entry into force from July while higher pay grades would see the contract applied only from September. The “13<sup>th</sup> monthly-payment” was frozen for a period of three years. Eastern public sector wages were brought to 82% of the Western levels.

The agreement was anyway welcomed as relatively positive by the unions who had managed to avoid the employers to push through their austerity demands, especially with regard to cuts in holiday entitlements (EIRR April 1994). The move toward concessionary bargaining vis-à-vis the employers eventually led to a realigned between the ÖTV and DAG. Until then, relations between the two unions had been cool due to competition for members in public services and transport. The unions were characterised by different strategies. With a membership skewed toward lower ranks and blue collar workers, ÖTV used to pursue a strategy of wage increases with a “social component”. This made it seek better improvements for lower-wage groups. On the contrary DAG, with the bulk of its members concentrated among the higher ranks and white collar workers, used to opt for linear wage increases. In July the two organisations made an agreement for future cooperation in order to better coordinate their wage demands. This signalled an improvement in the relations between the two unions (EIRR July 1994b).

On the employers’ side, during the summer Berlin was expelled from the TdL for having enacted a full wage equalisation between the public employees working in the Eastern and Western part of the capital. In fact, reunification had led to the paradoxical situation that public employees working in the same city would be subjected to different pay levels depending on whether they would be employed in the former Western or Eastern part. A draft law was put before the chamber of deputies by the Berlin Senate which aimed at a three-stage wage equalisation by October 1996. Fearing that this would spark requests for a fast equalisation throughout the whole public sector, the TdL expelled the city-state from the Länder employers’ association for

having acted on its own in a way that is “grossly detrimental” to the association (EIRR July 1994a).

With regard to the civil servants, the government did in fact pushed through a zero round. With legislation effected in August 1994 the government decided to grant a 2% wage increase, similar to that for the employees, only to the lower pay grades in the civil service (A1 to A8), effective as of October 1<sup>st</sup>. Civil servants in the grades above A9 were subjected to a wage freeze for the whole year 1994. Additionally, in November 1994 the government published a report on the reform of public services, putting forward a set of proposals to reform the structure of civil servants’ pay in order to bring it more in line with the private sector and with the NPM mantra. The report proposed the introduction of performance related pay and aimed at making job promotion subjected to a period of probation rather than automatic (EIRR November 1994b).

### *1995*

With figures reaching 14% in Eastern Germany and 8% in the West, unemployment became a key concern in German politics during 1995 (Poguntke 1996). The year was characterised also by a significant fiscal slippage which represented a serious deterioration vis-à-vis the government’s plan to rein in the budget deficit. In 1995 the deficit amounted to 3.5% as opposed to the 2.3% which the government had expected. These figures did not even take into consideration the debits (DM 204.6 billion) left by the closing (as of end of 1994) of the Treuhand agency charged with the privatisation of enterprises in Eastern Germany. Including these figures would have implied a deficit of around 9% of GDP in 1995. Overall, the fiscal slippage ensued from a shortfall in income and corporate tax revenues and the deficits of the social security system, mostly related to the health and pension funds. Additionally, in 1995 the new Länder were integrated into the fiscal equalisation scheme and this led to an increase of net transfers to Eastern Germany from 3.8% to 4% of GDP. With the entry into the system of the new States, the old Western Länder endured the reduction in the net transfers to their favour which led them to reduce investment and other expenditures (OECD 1996).

The negotiations for the public sector contract in 1995 were heavily influenced by those in the metalworking sector. Interestingly, however, rather than serving as a “pattern” for moderation, the agreement reached in the export industry worked to push up the pay settlement in the public sector. In the latter, the public employers’ confrontational stance taken in 1994 had slowed down the trajectory of public sector wages’ growth. Contrary to the pattern of wage moderation which had been followed in 1993 and 1994, in autumn 1994, IG Metall’s national executive committee advanced a wage request of 6% for the 1995 negotiations (EIRR November 1994a). With a cascade effect, the expensive “pilot” wage claim was immediately adopted by all major trade unions for the wage bargaining in other sectors of the economy (EIRR January 1995).

On March 7<sup>th</sup>, IG Metall sealed the pilot agreement for the metalworking industry in the Bavaria bargaining region which the union had singled out for a campaign of selective industrial action. The agreement envisaged lump-sums for the months from January to April and a subsequent 3.4% pay rise from May to October and a further 3.6% from November until the end of the year. Although well below the 6% request, the deal was criticised by the metalworking employers and, instead, was regarded by the unions as a victory. Indeed, IG Metall managed to breach the 3% which many economists had regarded as acceptable (EIRR April 1995a). After the “victorious” pattern was established, this set the pace for the negotiations and other sectors followed suit throughout March, namely the insurance sector, the chemical industry, the wood industry and the banking sector (EIRR April 1995b).

Exploratory negotiations in the public sector started on March 30<sup>th</sup>. In line with the pattern set by IG Metall, also ÖTV broke with the 1994 moderation and, in asking for a 6% increase, the union stressed that the public sector needed not to be decoupled from developments in the private economy. The public employers rebuked the request, highlighting their inability to pay in light of the “*empty public coffers*” (*leeren öffentlichen Kassen*) (WSI Tarifarchiv 1995). The Interior Minister Manfred Kanther specifically clarified that the public employers could not match the wage increases of the metalworking sector (Fisher 1995). In the second round of negotiations, at the end of April, the public employers submitted an offer of 2.5% for 15 months.

After a tense two-day negotiation in Stuttgart marked by the unions’ threat to escalate the conflict, an agreement was eventually reached with the public employers improving their offer to bring it more or less in line with the pilot agreement in the metalworking sector. After an initial offer of 2.5% by the employers, the deal was closed at 3.2% and a 40DM lump sum for the month of April. However, employers managed to extract the freeze of the Christmas bonus which, as a result, decreased from 98% to 96% of the monthly pay. In the end, the contract satisfied both camps. ÖTV deemed it as “just about acceptable” while the Interior Minister Kanther labelled it a “sensible” agreement (EIRR June 1995).

The provisions agreed in the public sector contract were applied to the civil servants with legislation effected in December 1995.

## 1996

Spring 1996 became a watershed moment in the history of Germany’s process of European integration. As envisaged by the Maastricht Treaty, in order to qualify for the single currency, a country’s general government fiscal deficit would have to be contained within the 3% of GDP target by the fiscal year 1997. Interestingly, on the 1<sup>st</sup> of June 1995 the German Finance Minister Theo Waigel had written an op-ed on the *Financial Times* to communicate his “personal views” to the political leaders across

Europe embroiled in the difficult process of convergence to the monetary union. Waigel bemoaned that “as things stand(ed), entry into the final stage of monetary union in 1997 is extremely unlikely because there seems scant prospect of a majority of member states fulfilling the Maastricht criteria by then”. “Public finance”, he went on, “is the area in which most action needs now to be taken”. Waigel championed the fact that only Germany and Luxembourg would by then qualify within the 3% deficit target and denounced that “nine of the fifteen member States” would fail in 1995 to meet the inflation and deficit criteria. As a result, he warned European leaders that “the monetary union will not be possible unless participants comply strictly with the convergence criteria” and that “there cannot and will not be any discounts or free tickets”. The Finance Minister thus recommended that “those (leaders) who seriously intend to achieve monetary union must now pursue a policy of fiscal consolidation” (Waigel 1995).

Indeed, at the moment of writing, Waigel could capitalise on a rebound of economic growth which had taken place during the first semester of 1995, a converge of inflation levels toward the 2% level and a budget deficit which the government had projected to fall to around 2.3% of GDP by the end of 1995 (OECD 1996). Yet, while Waigel became an increasingly vocal defender of fiscal consolidation abroad, he also simultaneously sowed the seeds of his own “rhetorical entrapment” at home. In fact, as it turned out, by spring 1996 the economic situation in Germany turned sour. Economic growth started to slow down from the summer of 1995, especially due to a fall in gross fixed investment and exports. In the last quarter of 1995 and the first quarter of 1996, economic growth faltered, recording a -0.2% and a -0.4% change on the previous quarter respectively (EIU 1996a, 21). The slowdown in economic activity, in conjunction with lower employment levels, generated a marked drop in tax revenues and a sharp increase in the expenditures of the social security funds. As a result, a significant fiscal slippage ensued and the budget deficit increased to 3.8% of GDP in 1996. With Waigel who had been insisting that the convergence criteria were not strict enough and that miscreants across Europe be fined, the overshooting of the German deficit came in as a severe embarrassment for the government at the beginning of 1996 (EIU 1996b, 16). By the spring of 1996 it became clear that, as things were, Germany itself would have exceeded the 3% target. With the fiscal space shrinking, the government’s fiscal policy turned toward the firm short-term objective of achieving fiscal consolidation to meet the (irrevocable) Maastricht budget deficit criterion (OECD 1997, Ch. II).

Due to mounting economic difficulties, the whole 1996 was also characterised by fierce conflicts between the government, the employers and the trade unions. Throughout the year, the highest number of unemployed people since the war was registered: more than 4.27m people were seeking jobs and the unemployment rate reached 11.1% in Germany (Poguntke 1997). At the IG Metall’s congress in early November 1995, the union leader Klaus Zwickel had announced his proposal for a “jobs pact” (*Bündnis für*

*Arbeit*). The leader proposed a controversial tripartite agreement which was received very critically by unions' delegates. According to the plan, the metalworking union would moderate its wage claims in line with inflation while workers would pile up overtime into "time banks" thus foregoing direct payments for extra work. Additionally, the union would agree to allow newly-hired workers to start with pay rates below the minimum rate agreed through collective bargaining contracts, only for a "limited period". In return, the leader asked the employers to avoid redundancies in the three years ahead and increase the number of training places by 5% a year. The government was instead asked to shelve plans to cut welfare and unemployment benefits (EIRR December 1995).

On the basis of the Chancellor's round-table discussions with the social partners, the government announced, at the end of January 1996, a fifty-point "Action Programme for Investment and Employment" which aimed at halving unemployment over the following four years. Above all, the plan intended to reduce public expenditures' share in national GDP by 4% points (see OECD 1996, 142-43; Box 5). The program envisaged a reduction of non-wage labour costs, support for small and medium-sized enterprises through tax breaks and a reform of the tax system to reduce income and corporate taxes. Under pressure from the junior FDP coalition partner, the government also committed to gradually reduce the solidarity surcharge from 7.5% to 5.5% in July 1996. The FDP was applying pressures within the coalition in light of the upcoming crucial Land elections in March. For the FDP, the three elections in Baden-Württemberg, Rhineland-Palatinate and Schleswig-Holstein on March 24<sup>th</sup> constituted a matter of electoral survival. After previous weak electoral results, these were three of the last four States in which the party was represented. Failing to meet the 5% threshold necessary to be represented in the Länder would have called into question the survival of the whole Christian-liberal coalition at the federal level as well (EIU 1996a, 8).

As a matter of fact, the March Länder elections constituted *the political turning point* which gave the momentum to Kohl's coalition and its EMU agenda. Given the difficult financial situation and the necessity to meet the Maastricht deficit target, Theo Waigel had made clear the government's intention to push through the fiscal measures needed at all costs. On March 14<sup>th</sup> the Finance Minister had enacted a legal provision for expenditure controls (*Haushaltssperre*) for which any form of discretionary spending in the federal budget would require the formal approval of the minister of finance (OECD 1997, 156). Given Kohl's government firm intention not to delay EMU accession, the Länder elections acquired the significance of a "vote of confidence" in the government's consolidation *cum* EMU-accession strategy. Most importantly, to challenge the CDU in one of its bastion region, in Baden-Württemberg the SPD had decided to campaign on the basis of a delay in the introduction of the single currency which constituted instead a non-negotiable objective for both Kohl and Waigel. The Land elections ended with considerable losses for the SPD which in Baden-Württemberg scored their lowest result until then (25.1%) (Poguntke 1997). Thus the

main opposition party suffered heavy losses. The rejection of the SPD's stance on EMU thus removed any questions on the political strategy of the federal government (EIU 1996a). Similarly, the FDP fared well and managed to increase its representation in the Länder.

This reinvigorated the federal coalition which could finally set itself on a firm consolidation stance. The scope was to bring the deficit in line with the requirements of the Maastricht criteria. By March, the tripartite talks for the jobs pact between Gesamtmetall and IG Metall were going nowhere. The employers insisted on the priority to achieve a 20% cut in total wage costs (via flexible work, cuts in social contributions and wage moderation) in order to withstand international competitiveness while the unions insisted on a formal guarantee on job creation and a ban on overtime to ensure new jobs (EIRR April 1996). After a series of nine sessions of tripartite talks, in April, the FDP economics minister Guenter Rexrodt declared the end of the "alliance for jobs" and the government eventually announced it would push ahead with a package of reforms necessary to reduce unemployment and make Germany more competitive internationally. Upon his return from holidays in Austria, on April 13<sup>th</sup> Kohl met with his cabinet and party officials to discuss "a plan of action" to execute welfare changes, tax reforms and the spending cuts necessary to give the country a chance of qualifying for EMU from January 1999. In the event, Kohl and Waigel signalled drastic spending cuts for federal, state and local authorities, without any "taboo" in the items to be affected (Peter Norman 1996c).

Rumours emerged that the coalition government intended to execute a savings plan of DM50bn to be shared between the Federation and subnational governments. Not only were Waigel and Kohl very determined behind the *sparpaket*, but also the senior ministers and leaders of the FDP were aligned with Waigel behind the planned savings measures (Peter Norman 1996b). Indiscretions came out that Waigel was planning to push strongly ahead for a two-year pay freeze in the public sector intended to be the bulk of the consolidation strategy. On April 16<sup>th</sup>, when asked by a journalist about his intention to pursue a wage freeze in the public sector, Waigel replied:

*"What was possible in Austria for two years, what was possible in Holland, what was possible in other countries, must also be possible in Germany in order to relieve the burden on public budgets, above all on the Länder and the municipalities, but also on the Federation" (ÖTV documental archive 1996).*

ÖTV's reply was not put back. Herbert Mai, the union's leader, immediately retorted that "a zero round is no offer, it is a diktat" and that they would resort to industrial action if the wage freeze remained on the table (Peter Norman 1996). The Bundesbank weighed in on the debate with Hans Tietmeyer warning the social partners that "a concerted effort was needed if Germany was to meet the Maastricht public sector deficit criterion of 3% of GDP" and that the Bundesbank "emphatically rejected any idea of weakening the Maastricht criteria to facilitate the start of EMU" (Peter Norman 1996d).

Eventually, on April 25<sup>th</sup> the coalition government approved the DM50bn savings package required to cut expenditures to fill the gaps in the finances of the federal, Länder and municipal governments. The plan envisaged reduced cuts in departmental budgets, reduced support for unemployment and children allowances and reduced transfers to the Federal labour agency and the pension funds. Most importantly, out of DM 50bn, the bulk of the fiscal adjustment had to come, for DM23bn (about half of the package), from a public sector pay freeze. Of these, due to the distribution of employment within the German administration, DM3bn had to be achieved through a freeze on wages at the federal level. The vast majority of the remaining savings (DM20bn) were to be achieved via a wage freeze at the Länder and municipal level (Peter Norman 1996a; OECD 1997, 34-35). Furthermore, the package aimed to reduce employers' payments for employees' sick pay to 80% of the basic wage for the first six weeks and to decrease the solidarity surcharge on income and corporate tax to finance the East by 2% points in two steps during January 1997 and January 1998.

However, the government had no legal right to impose the intended wage freeze on the public employees and needed to enter negotiations with the unions under the legal framework of independent collective bargaining. For sure, a wage freeze could have in theory been implemented through legislation for civil servants. This would have *de facto* also weakened ÖTV's bargaining position in negotiations for the public employees. Yet, given that the FDP leader Wolfgang Gerhardt was against the possibility to impose such a sacrifice on the civil servants, the coalition was split on the issue and this possibility faded away (Handelsblatt 1996). The industry employers (both BDA and BDI) mildly welcomed the package arguing that, while in the right direction, the package was not bold enough and more needed to be done. The DGB voiced its concern that the government had fallen prey to the employers' influence and had turned its back to the welfare state (EIRR June 1996b). The government intended to introduce the reforms as legislation before the parliamentary summer break in July. On the political side, however, the SPD immediately spoke against the package labelling it "socially obscene". Similarly, a few left-leaning MPs within the CDU/CSU/FDP were unhappy with the austerity plan (Financial Times 1996).

The fact that the SPD controlled the Bundesrat made it necessary for the Christian-liberal coalition to look out for compromises with the opposition party in order to push through those parts of the package which required the approval of the upper chamber. However, given that the SPD's veto in the Bundesrat would have necessarily slowed the reform process, shifting the extraction of fiscal savings onto the public sector wage setting arena represented a convenient way for the government to push through cuts as quickly as possible without going through the upper chamber. In fact, the Länder jointly rejected Waigel's tax plan to reform the wealth tax, the inheritance tax and the surcharge needed to finance the East. In a statement which crossed party lines, the Länder's leaders unanimously rejected the government's tax plans which they saw as easing the burden of the federal government at their expenses. At the same time though,

the Länder leaders signalled their intention to proceed with joint proposals on further budget cuts necessary to meet the Maastricht deficit criterion in the face of lower than expected state and municipal revenues (Norman and Fisher 1996). Indeed, what united the Länder across party lines was their troublesome financial condition (Financial Times 1996) which, in their function of public employers, urged the minimisation of the pay settlement's financial burden.

It was in this peculiar context that public sector wage setters bargained in spring 1996. On March 28<sup>th</sup>, the bargaining commission of the ÖTV had formulated its wage requests. It asked for a 4.5% increase for 12 months and the full equalisation of Eastern wages to those in Western public sector. At about the same time, the pilot agreement (*Pilotabschluss*) for the 1996 bargaining season was reached in the chemical industry after negotiations in the state of Rhineland-Pfalz. The deal provided for a modest pay rise of 2% in return for job security guarantees and job creation (EIRR May 1996; Tarifarchiv 1996). Before the official public sector wage negotiations started at the end of April, the ÖTV had entertained talks with the public employers on the possibility of an "alliance for jobs in the public sector". Meetings turned out to be unproductive and the attempt failed in mid-April (WSI Tarifarchiv 1996). During the first rounds of negotiations between the end of April and the beginning of May the public employers submitted a "seven-point list" of demands. They called for longer working hours, a reduction in sickness pay and overtime pay, the conversion of overtime into holidays rather than extra pay, an increase in part-time employment, the implementation of early retirement provisions and the promotion of more temporary employment.

The parts clashed on the entity of the fiscal savings to be achieved. The Interior Minister Kanther leading the employers' delegation stated that "a two-year pay freeze and cuts in sick pay for 3.2 m public sector employees is the only realistic option considering the massive public budget deficit". ÖTV's chairman Herbert Mai insisted that the "public sector employees' salaries are not a secret reserve cash box for the nation". By late May, after three wage rounds, no compromise seemed on the horizon and around 10.000 public sector workers took the streets to protest against the wage freeze, cuts in sickness pay, the loss of two days of holiday and cuts in Christmas and holiday bonuses demanded by the public employers (EIRR June 1996a).

When the unions met for the fourth round of negotiations on May 22<sup>nd</sup>, the employers offered a one-time pay rate of 0.5% for 1996 and a 1% from May 1997 with twenty-month contract duration. The proposal was bluntly rejected by the unions and both parts referred to the arbitration procedure (WSI Tarifarchiv 1996). After two weeks, the arbitrators' commission, chaired by a bipartisan duo (Carl-Ludwig Wagner (CDU) and Hans Koschnick (SPD)), issued a unanimous compromised proposal. This included a one-off payment of DM300 (amounting to 0.8% of average incomes) for the year 1996 for all public sector workers, a pay increase of 1.3% for the year 1997, a pay freeze for trainees with a guarantee to create 1.200 additional training places, a freeze on the level

of the Christmas bonus and the replacement of one day of granted extra holidays with the requirement to work two half-days on Christmas and New Year's eve.

The whole package, estimated by Waigel to be around 1% by the end of 1997, was not deemed as a climb-down by the government but rather, given also other developments in the economy, the public employers regarded it as "reasonable". They also rejoiced the longer duration of the contract which made "planning easier". Although admittedly meagre for the public workers, on June 20<sup>th</sup> the trade union representatives eventually accepted the arbitrators' proposal. ÖTV and DAG cheered the fact that they could circumvent the wage freeze forcefully wanted by the Finance Minister and managed to avoid sick pay reductions and longer working hours (EIRR July 1996)

In analysing the 1996 fiscal year, the IMF action-based database on fiscal consolidation describes developments in Germany as follows (Devries et al. 2011, 42):

*"Fiscal consolidation in 1997 was primarily motivated by deficit reduction and meeting the Maastricht deficit criteria ... To shore up the public finances, the authorities adopted in late 1996 substantial discretionary fiscal measures as part of the budget for 1997, which were heavily weighted on spending cuts ... With these measures, the authorities expected that the general government deficit would decline to 2% of GDP in 1997, safely under the Maastricht reference value. Spending cuts in the 1997 budget amounted to 1% of GDP and were based on wage restraint and retrenchments, spending limits imposed at the federal and state level, reducing sick pay coverage and restricting spa visits, and tightening eligibility for unemployment benefits."*

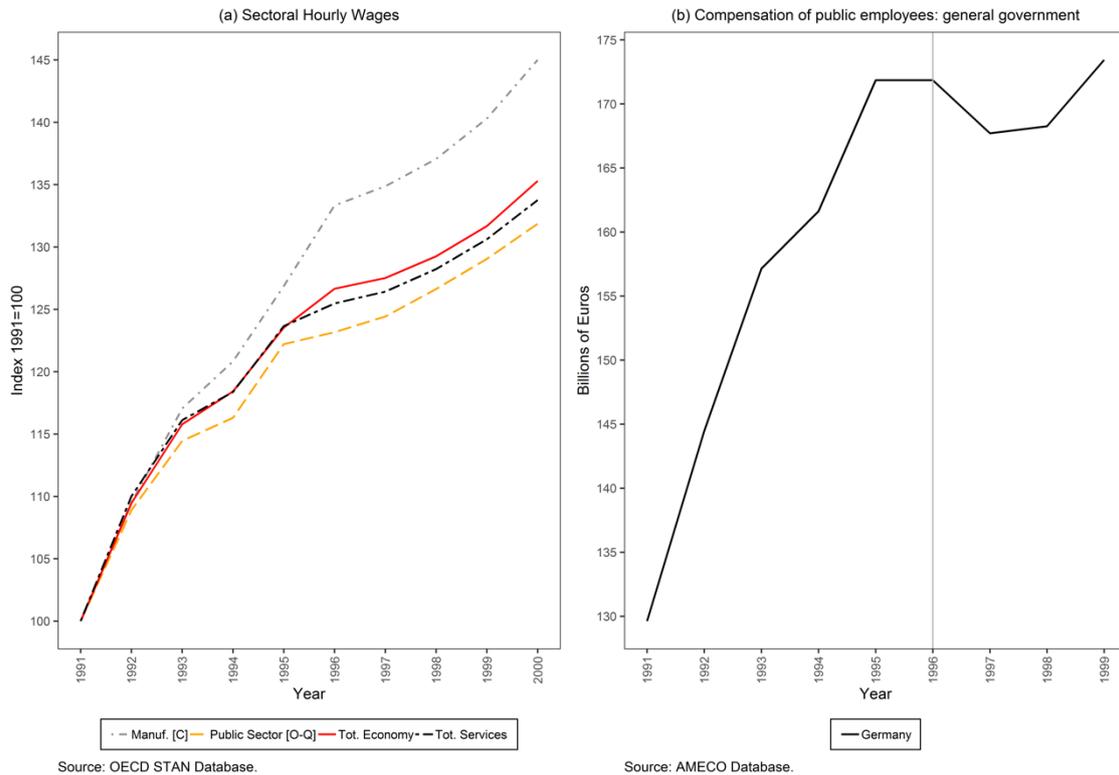
With legislation effected in March 1997, similar provision to those agreed for the public employees were applied to the civil servants who received a lump sum of DM300 for the year 1996 and a 1.3% wage increase valid as of 1<sup>st</sup> of March 1997 for most of the employment categories within the civil service. With a very modest contract, valid for twenty months the German public sector, Germany made it to EMU and headed toward the new century when new types of pressures emerged within the public employers' camp.

### 6.3 ANALYSIS OF THE 1990S

Figure 12 depicts the trajectory of public sector wage setting in Germany during the 1990s. Panel a shows that public sector wages start to diverge from the other sectors of the German economy from 1994. Public sector wage restraint is even more pronounced than restraint in the total service sector. The divergence becomes more marked through the wage restraint pursued in between 1996 and 1997. Panel b shows a clear cut adjustment of personnel costs for the fiscal year 1997.

Wage restraint during the 1990s emerged out of a combination of public employers' unilateral action (in 1994) and negotiated restraint in independent collective bargaining with the unions (in 1996). Figure 13 provides a diagram visualisation of the sequence of events which led to the juncture of wage restraint in 1996-1997. Before summing up the causal chain of events, three wider considerations are of order.

Figure 12: Trajectory of public sector wage setting during the 1990s

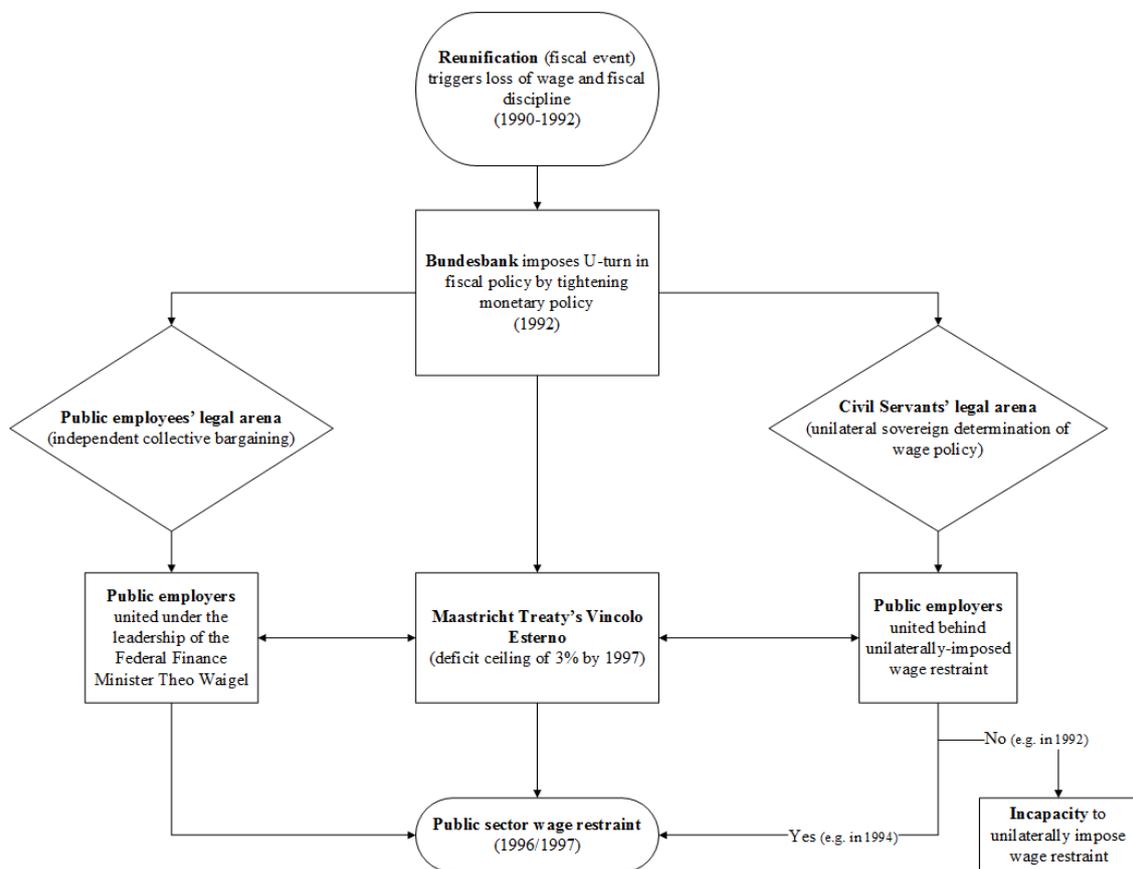


First, the evidence is incongruent with the predictions of the “*Ordmerkantilismus hypothesis*” introduced in the literature review. According to such an explanation, we would have expected to observe wage restraint in the German public sector to have been pursued by the government as a part of a wider strategy of economic mercantilism to engineer an undervaluation of the German economy vis-à-vis its EMU peers. The issues of export competitiveness, inflation and real exchange rates – which would be the crucial components of such a strategy – have played no role in public sector wage bargaining. What motivates the public employers to seek for restraint is the financial burden which wage setting imposes on the public coffers. When acting with respect to their function of public employers, governmental actors across the three levels of the German public administration were primarily moved by the fiscal imperatives of the organisations they were responsible for.

Second, the evidence observed does not validate the “*export-sector domination hypothesis*” either. I could find no evidence of a moderating influence of the export sector over the pay settlements in the public sector via the institutions of inter-sectoral wage coordination. As a result, not even the “*the pattern bargaining hypothesis*” can be considered valid. Wage restraint in the German public sector stems from logics which are almost entirely decoupled from export sector wage setting. During the 1990s two sorts of institutional constraints have exerted “exogenous” pressure on the public employers. In the immediate aftermath of reunification, the Bundesbank acted as a sort of *vincolo interno* (internal constraint). Through a policy of tight money which was

unprecedented for its strength and duration, the Bundesbank used its legal independence to rectify the loss of fiscal and wage discipline by the government, the wage setters *and the government in its function of wage setter for the public sector*. In the latter phase of the 1990s, after the Bundesbank had been gradually relaxing its stance, the Maastricht deficit criterion acted as a *vincolo esterno* (external constraint). When, in spring 1996, it became clear that Germany itself would have not qualified for EMU by the fiscal year 1997, the government embarked on a “whatever it takes” strategy of fiscal consolidation. It did so under the firm leadership of the Finance Minister Theo Waigel. To meet the Maastricht deficit criterion, the Christian-liberal coalition coalesced behind the Finance Minister and advanced a DM50bn savings package whose core savings were to be achieved thanks to a two-year public sector pay freeze.

Figure 13: Causal chain of public sector wage restraint during the 1990s



It was in this context of urgent and irreversible fiscal emergency that the public employers of the three administrative layers overcame “party-politics differences” and united behind a firm strategy of fiscal consolidation. Although the legal framework did not allow the government to impose the wage freeze on the public employees, *even without making use of their sovereign authority* the public employers, united within the governing coalition and vertically (across the federal government, the States and the

municipalities) pushed the unions against the wall, forcing them to cave in and accept a very modest concessionary agreement in 1996. In the bargaining process wages were but one of the many dimensions to be affected. Wage setters negotiate simultaneously on a set of different qualitative and quantitative aspects of the employment relation. As such, the emphasis on wages which is present in the literature hides the fact that interactions among real wage bargaining actors have the nature of *multi-issue bargains* whereby what is being negotiated at any point in time goes well beyond wages. Unions have had to defend themselves against the public employers' offensive on working hours, sick-pay entitlements, Christmas and summer bonuses, holidays and extra work. In the event, they gave up on wage restraint but protected some other aspects of the employment relation.

Does this mean, however, that inter-sectoral wage bargaining developments between the export and the public sector did not matter in Germany? No, they did matter but not in the way the institutionalist literature on wage bargaining systems has so far pointed out. The historical reconstruction shows that *the wage settlements in the export industries have, at times, exerted upward pressure on the pay settlements of the public sector*. With public employers firmly committed to impose wage restraint out of financial considerations, the higher settlements in the export industry which served as "pilot agreements" rather created upward "imitative pressures". The public employers had to depart from their initial intentions to push for more moderate or even "zero" wage rounds in the face of higher pilot agreements in the export industry. In other words, in order to escape moderate wage offers or even the threat of a pay freeze, the unions could often "play the wage pattern" already agreed in the export industry against the public employers. In so doing, they applied pressures on them to revise their initial stingy offers upward. Reasoning counterfactually, it could be speculated in disagreement with the pattern bargaining explanation that:

*had the pilot contracts in the export sector not been signed before public sector negotiations, the public employers would have probably had even more leverage to push through further fiscal consolidation than the restraint they already managed to obtain.*

Third, even where they potentially could, German public employers have often refrained from deploying their sovereign power in public sector wage setting. This occurred because they were internally divided. Most notably, the issue of imposing a statutory pay limit on the civil servants came out prominently in German politics in 1992 with the FDP economics minister Jürgen Möllemann. In an *exceptional* phase in which wage and fiscal discipline was lost and a wage-price spiral had ensued, Möllemann intended to exploit the public employers' sovereign authority to send a signal to the private sector and to weaken unions in public sector collective bargaining. Interestingly, the 1992 negotiating round shows that internal dividedness within the employers' camp can undermine their actual capacity to deploy their sovereign authority in public sector wage setting. In the event, a conflict of interests emerged between the economics and interior ministries which also cut across party lines. The

FDP which controlled the economics ministry was pushing for a strategy of “hierarchical direction”, namely to use legislative powers to force wage and fiscal restraint in the polity against the will of the militant unions. The CDU-controlled Interior Ministry, where the legal competence for wage setting rests, firmly rejected Möllemann’s proposal. The Interior Minister Rudolf Seiters publicly attacked the economics minister and rebuked him for interfering in matters beyond his ministry’s responsibility. As a result of public employers’ internal dividedness, sovereign power was not deployed.

In all, during the 1990s the public employers remained united in collective bargaining negotiations within the public sector *Tarifgemeinschaft*. This meant that public employers negotiated jointly in wage bargaining under the leadership of the Minister of the Interior. This leadership will be challenged by the Länder employers in the 2000s. A crucial reason for why unity was preserved within the public employers in the 1990s was that strong financial divisions were delayed thanks to two factors. On the vertical level, the fact that the unification bill was mainly footed by the federal budget softened the financial pressures on the Länder. On the horizontal level, tensions between poorer (new) Länder and richer (old) Länder were initially neutralised. This was possible because, due to the old Länder’s veto, the entry of the new Länder into the fiscal equalisation system was delayed until 1995. After 1995, the entry into the system of the new States will mean lower transfers to the old Länder and more redistribution to the east. This will contribute, in the 2000s, to make relationships among the public employers more difficult, triggering the necessity for a new compromise to be found through a process of institutional change. Financial tensions among the German employers will be the trigger behind the necessity to negotiate an overhaul of the wage bargaining structure and of the federal government’s competence to legislate on the civil servants’ pay terms during the reform of fiscal federalism. We will soon see how a new compromise will be institutionalised during the early 2000s.

To recap on the causal chain of the 1990s (figure 13), it should be said that in the immediate years after reunification both the public and private sector trade unions went on the offensive, demanding compensation for inflation and the tax hikes needed to finance reunification. A confused government, burdened with the challenge of organizing the integration of a command economy into the West-Germany’s model of capitalism, initially tolerated budget deficits and relatively high pay settlements in the public sector. To their merits, in 1992 the public sector unions showed great associational power and the industrial conflict which ensued – one of the biggest in Germany’s post-war history – shared the sympathy of the wider public. The policy environment changed, however, when the Bundesbank hardened monetary policy, inducing an economic recession and high unemployment. Public employers were forced to make a U-turn on fiscal policy. Again, Keynesianism in Germany proved to be a no go. This was not so much for lack of political willingness or an inherent preference for an export-led growth model but because of the non-accommodating

stance of the Bundesbank. In public sector wage setting, when the available fiscal space tightened up and deficits emerged, the public employers' ability to pay was compromised. This triggered an increasingly assertive stance on public sector wage setting. In 1994 the public employers did use their legislative authority to impose a yearly wage freeze to the civil servants. This marked the beginning of the trajectory of public sector wage restraint and wage dualisation observable the German political economy (figure 12).

In 1996 the public employers united under the leadership of the Finance Minister Theo Waigel extracted budget savings without the use of their sovereign authority. They did so through independent collective bargaining with the trade unions. A moderate wage settlement in the public sector was instrumental – and perhaps crucial – for Germany to meet the legal obligations it had stipulated the European counterparts in Maastricht. Since Theo Waigel had styled himself as the stubborn defender of financial stability in the single currency, had Germany failed to meet the Maastricht criteria itself, the German government would have been severely embarrassed internationally. The fact that Waigel had in many occasions publicly mocked Southern European leaders for failing to meet the criteria certainly did not help. Ironically enough, German Finance Ministers will be haunted by the provisions of the Stability and Growth Pact throughout the early 2000s.

Concluding with a thought experiment on the history of the German political economy over the course of European integration, one could speculate counterfactually what follows:

*given the veto which the SPD and the Länder were exercising in the Bundesrat against most of fiscal reforms proposed by the government to bring down the deficit in 1996, had the German public employers not pursued forcefully a policy of remarkable public sector wage restraint in light of the 1997 fiscal year (in the public sector wage arena they could circumvent the SPD's opposition and unite the Länder in their function of public employers), Germany would have most likely failed to meet the Maastricht criteria itself. Were that to be the case, the very EMU creation would have been delayed and probably the EMU would have been created as a regime of a very different nature.*

Possibly, without the pursuit of a harsh policy of public sector wage restraint in Germany the history of the whole continent would have developed differently. This indicates, in my view, the significance of public sector wage setting in the EMU. The German case shows that public sector wage setting has enormous causal relevance for processes and outcomes of fiscal policy coordination in Europe.

## **CHAPTER 7. THE 2000s. THE DOUBLE LÄNDER OFFENSIVE: INSTITUTIONAL AND CONSTITUTIONAL REFORMS OF PUBLIC SECTOR WAGE SETTING**

This chapter covers the developments of the 2000s. It contextualises them against the background of the fiscal crisis of the German state and links them to the tax reforms pursued by the Red-Green coalition. The chapter is divided in three sub-sections. In 7.1 the process of institutional change of the collective bargaining framework is reconstructed. In 7.2 I look at the process of constitutional reform of the German federalism system and show how this unfolded in parallel and in relation to the developments described in 7.1. I posit that to appreciate fully these developments they should be read and interpreted together. Sub-section 7.3 concludes the chapter with critical analyses of these developments in light of the alternative explanations derived in the literature review.

### *7.1 WAGE RESTRAINT IN THE CONTEXT OF INSTITUTIONAL REFORMS OF THE WAGE BARGAINING STRUCTURE*

In September 1998, the SPD won the Bundestag elections after sixteen years in the opposition. The Red-Green coalition which was formed as a result had made tackling Germany's chronic unemployment through a concerted action – a renewal of the alliance for jobs - its prior commitment. The SPD won a clear victory vis-à-vis the CDU/CSU, with its Chancellor candidate Gerhard Schröder positioning the party around the “new centre” (*Neue Mitte*), focused on a supply-side oriented left-wing strategy.

The beginning of the coalition was marked by two internal political conflicts. On the one hand, Schröder was reluctant to second the Greens' policy priorities (dual citizenship for immigrants and nuclear energy policy). On the other, the SPD was captured in intestine conflicts between the “economic modernisers” who flanked Mr Schröder and the “left-wing traditionalists” spearheaded by the party chairman and Finance Minister Oskar Lafontaine (Poguntke 2000a). The latter, a convinced Keynesian, had become something of a “loose cannon” in the first months of the coalition. In the months which followed the formation of the cabinet, the Finance Minister advanced a tax reform meant to be a “Keynesian demand stimulus, Lafontaine style” for whose implementation the Finance Minister, in a clear challenge to its statutory independence, publicly called on the Bundesbank to cut interest rates (Lees 2000, 121-28). The Finance Minister also intended to craft a less orthodox monetary framework of the EMU and a more expansionary fiscal policy in Germany. This strategy was increasingly challenged within and outside the party to the point that, in

March, Lafontaine eventually resigned as Finance Minister and as party chairman in order to abandon public life. With Lafontaine out of the game, Hans Eichel took over the Finance Ministry and in the second half of 1999 the government embarked on a policy of moderate budgetary consolidation.

### *1999<sup>24</sup>*

The 1999 bargaining season acquires relevance for two interrelated reasons. At the sectoral level, the first agreement sealed under the Red-Green coalition at a 3.1% resulted in a victory of the unions and unleashed a rift among the public employers who became very vocal about the expensive pay settlement. At the local level two path-breaking accords were reached to deal with the specific needs of the municipal employers. These will serve as the basis for the reform of the whole collective bargaining structure in the years to come.

In mid-December 1998, the ÖTV's negotiating commission had opted for entering the 1999 bargaining round with a wage request of 5.5% for twelve months. In addition, the union was seeking to bring back to 100% of the salary (75% in the East) the Christmas bonus which, in previous contracts, had been frozen at the level of the 1993 salary. Negotiations started at the end of January and by the second round in early February, the employers had not yet submitted an offer (WSI Tarifarchiv 1999). After two rounds of failed negotiations, followed by warning strikes in 155 cities with about 100.000 employees mobilised, on 27 February the public sector wage setters settled on a lump sum of DM 300 for the first three months of the year and a 3.1% from April. The contract, again, envisaged a longer duration of 15 months (EIRR April 1999).

The unions were satisfied with the generous deal which was well above inflation. On the employers' side, the deal was very controversial. Controversy emerged on what they deemed as an "unacceptable burden upon central and local government expenditures". Although the parties had agreed on a declaration of intent to conclude a collective agreement on the introduction of more flexible forms of working time by July 1999, employers warned about the loss of jobs at all levels of the administration due to the high costs of the deal. Public employers had come under pressure due to the pilot agreement reached by IG Metall in mid-February in the Baden-Württemberg bargaining region. The unions in the metalworking industry had managed to extract an above-inflation settlement on the basis of a DM350 lump sum for January and February and a subsequent 3.2% pay increase from March (EIRR March 1999). Public employers wanted to avoid an expensive settlement which would have put under

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<sup>24</sup> In the 1998 bargaining season the trade unions in the public sector obtained a 1.5% wage increase which was then transferred to the civil servants via legislation effected in August 1998. The bargaining round is not review here due to its low saliency. A review of the year's developments can be obtained via the website of the *WSI Tarifarchiv*.

renewed strain the public coffers. Yet the 3.2% pay increase in the metalworking sector – which was largely copied by most of the other sectors – put upward pressures on the public sector deal. In fact, any public sector settlement below that level would have enlarged further the damaging widening of public and private sector pay differentials, causing recruitment and retentions problems which the public employers wanted to avoid (EIRR August 1999; April 1999).

In the meantime, in mid-February, a significant agreement had been signed in the private waste-disposal industry between the ÖTV and the BDE (*Bundesverband der Deutschen Entsorgungswirtschaft*). BDE represented about 1.000 medium-sized companies in the industry but the contract acquired great importance because ÖTV agreed that, for the newly-hired, the level of the entry wages could be lower than that envisaged by the collective agreement by up to 25%. This was the beginning of open clauses which could derogate the collective contract *in pejus*. While ÖTV had been on the defensive side against the employers who were trying to reduce wages of current employees, BDE's chairman Gerhard Scheele welcomed the agreement as the right step in the direction of more cost competitiveness. In fact, many of the companies in the industry had recently quit the employers' association due to the high costs of the contracts (Eurofound 1999b). This is a provision, favourable to municipal employers, which will be taken up in the reform of the old BAT system and the creation of the TVöD framework in 2005.

In fact, at about the same time, a milestone collective agreement (TV-V, *Tarifvertrag Versorgung*) was signed between ÖTV and DAG with the municipal public employers (VKA) in the sector of public utilities. The deal was widely regarded by all parts as the pilot agreement to look at for the modernisation of public sector industrial relations and the reform of the wage structure - which would follow in the mid-2000s. The package deal eliminated for the first time the legal distinction between the blue-collar workers and the salaried employees. It provided for a uniform grading and pay system which unified the previously distinct categories. It also introduced elements of performance-related pay and elements of flexibility in the working hours which were sought by the employers. In the event, both ÖTV and the employers regarded it as a compromise on the way to modernise public sector employment relations by ensuring more competition without eroding labour standards (Eurofound 1999a).

After the wave of new contracts, in the face of a severe fiscal slippage, the Finance Minister Hans Eichel (who had replaced Lafontaine) was forced to introduce a DM30bn multi-year savings package in June. The package was composed mostly of spending cuts (OECD 1999, 54). Given the tightening of the fiscal space, Schröder “flirted” with the idea of imposing a statutory limit on civil servants' pay as part of the consolidation plan. In other words, after the costly agreement reached in February, Schröder intended not to transfer via legislation the same provisions agreed with ÖTV (3.1%) for the public employees to the civil servants, thus breaking with the tradition of “intra-public sector wage coordination” led by the federal legislators. Schröder

proposed to limit the legislated pay increase for the civil servants to 0.6%, the inflation level. In so doing, the Chancellor defended the policy as “an acceptable contribution to the consolidation of the state deficit”. Indeed, by imposing a two-year statutory limit on some 1.7m civil servants, the federal government hoped to rectify the generous pay deal in the public sector by saving some DM1.8bn (Eurofound 1999c).

Yet political reality compounded matters and reduced the scope for deploying sovereign authority in public sector wage setting. Electorally, the coalition had been weakened by the results of all 1999 Land elections. The greens had lost substantially while the SPD’s fortunes were revised downward. At the June European election both the Greens and the SPD suffered losses. The former especially lost 50% of their votes if compared to the 1994 election. The decisive moment which marked the weakest point of the coalition was the Saxony Land election in September where the Greens landed nowhere while the SPD went down to 10% from its previous 16.6% (Poguntke 2000b). Besides intra-coalitional problems, Schröder was faced with the neat opposition of both the civil servants’ union (dbb) and the DGB. Indeed, dbb’s head Herhard Geyer urged the Chancellor to conduct the bargain “responsibly” and warned the Chancellor that the civil servants no longer wished to be “the piggy bank of the nation” (EIRR January 2000). When, on October 19<sup>th</sup>, between 60.000 and 70.000 public sector employees took the streets of Berlin to demonstrate against the Government’s “statutory pay diktat” (*staatliches Besoldungsdiktat*), the federal government abandoned its intention. Eventually, with legislation effected in mid-November 1999, the government transferred slightly similar provisions of public sector contract to the civil servants who obtained a 2.9% increase. Political weakness had *de facto* trumped the government’s capacity to impose restraint through state sovereignty.

2002<sup>25</sup>

In March 2001 the landscape of public sector trade union representation was overhauled. After years of preparations, a new collective actor in service-sector trade unionism was formally launched. With about 3m members in 2001, the new trade union Ver.di became the world’s largest union overcoming IG Metall (Keller 2005b).

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<sup>25</sup> In the year 2000, after anguished bargaining rounds and the rejection by the unions of the arbitrators’ proposal, the parts eventually settled on a DM400 lump sum for the months January to April, a 2% pay increase as of August 2000 with a further 2.4% from September 2000. Unions were satisfied with the improved which they had managed to push up from the initial offers by the employers. Employers on their part were satisfied for they had managed to extract a contract for the record duration of 31 months (EIRR July 2000). The agreement was reached as a last-minute compromise after the public employers had declared their financial inability to improve the arbitrators’ offer and the unions were ready to call a strike (Eurofound 2000). For the civil servants the government delayed legislation until April 2001 when it granted a 1.8% increase for the year 2001 and a 2.2% for the year 2002. For the year 2000 the government only granted for the period September to December a DM400 lump sum. See also the yearly bargaining round as described by the *WSI Tarifarchiv*.

Ver.di was the result of the merging of 5 unions: the white-collar workers union (DAG), the media-workers' union IG Medien, the postal workers' union (DPG), the banking and insurance union (HBV) and the ÖTV. Of these, ÖTV was by far the preponderant union with about 1.5million members. The creation of the conglomerate union had been set in motion already in autumn 1997 to counteract the increasing organisational financial difficulties linked to declining membership throughout the 1990s. Moreover, with the merger it was hoped to solve demarcation lines among competing unions in the service sector, notably in the knowledge economy, banking and insurance where HBV and DAG had been long competing (EIRR April 2001).

During the process which led to the creation of Ver.di , the unions experienced several organisational difficulties due to their diverse nature and their membership base spanning both the private and public sector. In the process, smaller unions were afraid of an excessive preponderance of ÖTV into the new organisation. ÖTV on the contrary was afraid of losing its identity in a conglomerate union with smaller industry-specific unions. ÖTV in particular experienced internal problems throughout the year 2000 which made it unclear whether the 80% majority needed to approve the merger would be obtained at the internal conference in March 2001. In the preliminary ÖTV congress in November 2000 the merger had been approved by the members with a mere 65% majority. This allowed the continuation of preparations for the merger although it cast doubts on the capacity to arrive at the required 80% majority in the final congressional vote. Under this uncertainty, ÖTV's head Herbert Mai resigned just to be replaced by Frank Bsirske. The other unions, in the meantime, had reached an agreement committing to push ahead with the merger anyway, even without ÖTV. At any rate, against the expectations of the many, on March 16<sup>th</sup>, the conference of ÖTV approved the merger with an 87.1% majority. As a result, Ver.di was created. As an organisation, Ver.di consists of a horizontal structure composed of thirteen departments covering various areas of activity and a vertical structure composed of three division covering federal, state and regional areas. Thus, Ver.di took over the role of negotiating leader for the public sector in 2002.

At the September 2002 federal election, the red-green coalition returned to government with a very slim majority. The SPD had campaigned on the necessity to tackle high unemployment promising that full employment would be achieved incrementally. The coalition agreement negotiated between the SPD and the greens in mid-October committed the coalition to the reform of the labour market in line with suggestions advanced by the "Hartz Commission" which had been appointed in August 2002. Furthermore, the government intended to continue the consolidation of the public budget, with the Finance Minister Hans Eichel promising to balance the budget by 2006 (Eurofound 2002). Things turned out rather differently.

In fact, fiscal policy in 2001 had been expansionary due to the gradual entry into effect of the Schröder's tax reform of the income and business taxes. Reform measures had been phased in by the Red-Green government since 1999. On the personal income

taxes, the government had envisaged a wave of subsequent reductions to bring the bottom statutory tax rates from 25.9% in 1998 to 15% by 2005. The top statutory tax was meant to reach 42% over the same time, down from 53% in 1998. The government also raised benefits and exemptions for children allowances and increased the basic tax-free allowance from DM 12.300 to DM 15.000. On the taxation of businesses, the tax rate for incorporated companies was brought to 25% for both retained (from 40%) and distributed (from 30%) profits (OECD 2001, 52-54; see Box3).

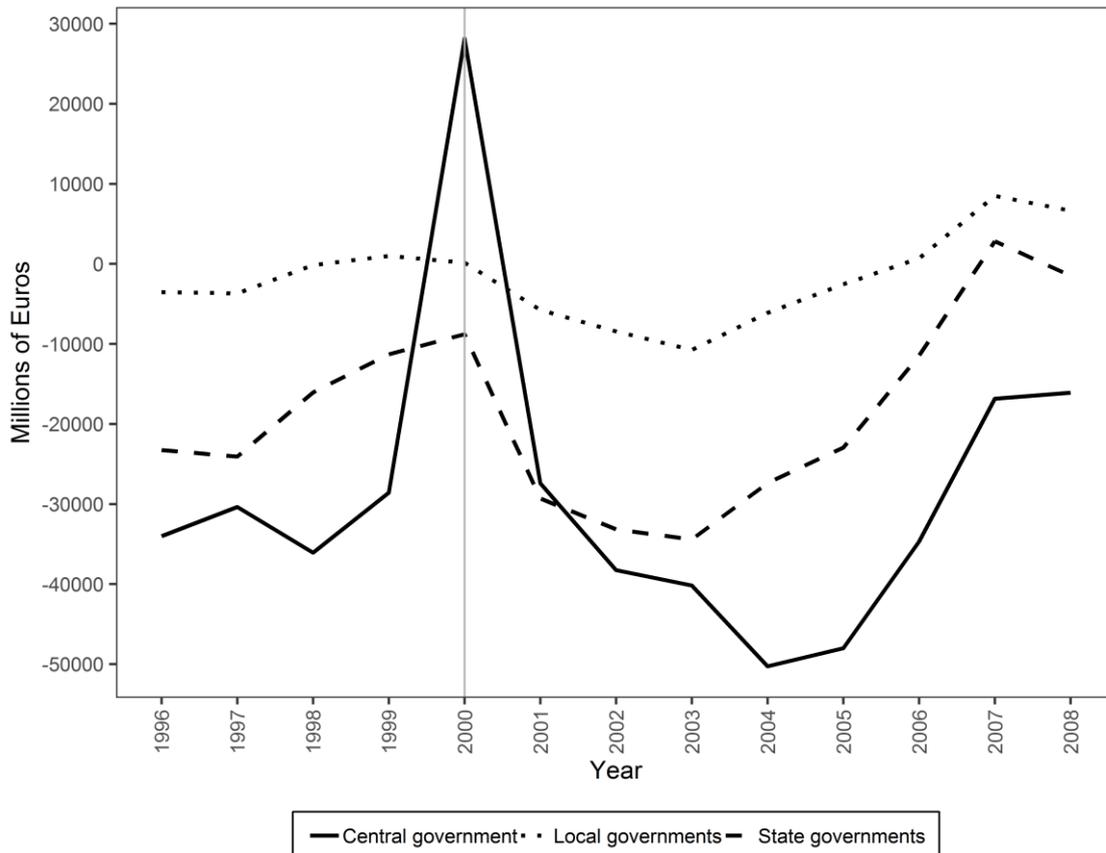
In all, the combination of foregone revenues linked to the tax reform and higher social transfers caused by slower economic growth, increased the 2001 structural deficit to 2.8% of GDP. This caused the government to overshoot its fiscal target as laid down in its 2000 Stability Programme by 1.25% of GDP. Government finances were heavily affected by the 2001 step of the entry into force of the tax reform. Foregone revenues amounted to more than 1% of GDP. Corporate income tax receipts fell abruptly and also VAT receipts, the single largest tax item, slowed down (OECD 2002, Ch. II). Due to the collapse of tax receipts from income, VAT and business taxes, the finances of the Länder were particularly affected. As a result of the reform, Länder's deficits more than tripled over the course of the years 2001-2003 (figure 14). As a matter of fact, the bloody wound inflicted to the Länder's finances by the Schröder tax reforms, opened a cleavage between the federation and the Länder's public employers which will turn out to be fatal. It was in this context that Pedro Solbes, the "quiet commissioner" for economic and monetary affairs of the Prodi Commission, became the man in the news for his decision to give Germany a public warning on the risk that its budget would soon breach the Stability Pact's ceiling of 3% (Financial Times 2002).

Public sector negotiations began late in 2002. The previous contract, agreed in June 2000, envisaged the record duration of 31 months and was thus due to expire at the end of October 2002. In its first wage request advanced in late October, Ver.di signalled a break with tradition. ÖTV used to enter negotiations with higher wage requests, aligned or at times above the other economic sectors, to then compromise downward. Ver.di's chairman Frank Bsirke emphasized a departure from the "usual bargaining rituals" and instead oriented Ver.di's strategy toward a more pragmatic approach. Ver.di foregone a pay request similar to other sectors' claims (5.5% and 6.5%). Instead, it opted for a "realistic" request of "more than 3%" for a 12-month period and full East/West wage equalisation by 2007. While Ver.di stressed that the pay of skilled workers in the public sector should not lag behind developments in the private sector, the public employers promptly dismissed Ver.di's requests on the grounds that an increase between 3% and 4% would increase fiscal spending by around €6.6bn.

In the face of worsened financial conditions, Länder and municipal employers became increasingly more vocal. The Bavarian Finance Minister Kurt Falthäuser argued that, given the tight fiscal space, the public employers' ability to pay amounted to "between zero and moderate increases" (EIRR November 2002). Similarly, the SPD Berlin mayor Klaus Wowereit urged a zero round. The SPD Prime Minister of Schleswig-

Holstein, Heide Simonis (SPD), demanded opening clauses to deviate on collective agreements, especially with regard to Christmas bonuses. At the same time, the VKA initially called for a zero wage round and then proposed to delay negotiations altogether by half a year (WSI Tarifarchiv 2002).

Figure 14: deficits of administrative levels in Germany (1996-2008)



Source: OECD (Central Government's 2000 surplus due to the proceeds from the auctioning of UMTS licenses).

The first round of negotiations failed in mid-November. As exploratory talks continued without progress in December, unions staged warning strikes with some 110.000 employees disrupting local transportation, hospitals, waste collection, airports and childcare facilities across 200 cities. At the second round, employers offered a 0.9% pay increase as of January 2003 plus a further 1.2% from October 2003. Employers offered a €40 single payment for lower income groups in November and December but they pretended a 30-minute increase of the working week (up to 39 hours per week in the west, (up to 40 in the East) and an agreement on the reform of the collective bargaining structure by the end of 2004. Ver.di's negotiating commission bluntly rejected the offer which was banned as "as a provocation". Thus negotiations collapsed and Ver.di asked for the arbitration procedure (EIRR January 2003).

On 6 January, the arbitration commission led by the SPD former mayor of Bremen Hans Koschnick (SPD) submitted an offer including a pay increase of 2.4% from January

2003 and a further 0.6% from January 2004 together with a lump sum up to € 216 (€ 194.4 in the East). Additionally, the arbitrators recommended the Christmas bonus be frozen until the end of April 2004, the introduction of lower entry-level wages for newly-hired, the alignment of East/West wages by 2007 through six steps and the obligation to redesign the collective bargaining structure in the public sector by April 2004.

On the following day, Berlin decided to resign its membership in the VKA and in the Association of Employers' Public service (*Vereinigung der Arbeitgeber des öffentlichen Dienstes, VadÖD*) (a regional subsidiary association which had been created after Berlin had been expelled from TdL in 1993). In so doing, Berlin's authorities argued that the delicate budgetary situation of the city did not allow them any option other than to leave the employers' association and seek a cheaper agreement. In fact, Berlin's mayor Wowereit attempted separate negotiations with Ver.di. The Berlin SPD-PDS coalition government tried to achieve a less costly agreement on the basis of a "solidarity pact model". The mayor proposed a multi-year wage freeze, a reduction of the annual bonus and the elimination of the summer bonus in exchange for a reduction in employees' working time as well as a job guarantee. Ver.di however refused to enter separate talks in order not to let employers' deviate from the national agreement (Behrens 2003). The dispute continued, highlighting the increased tensions between the SPD and Ver.di. Berlin's strategy against Ver.di rested on a strategical division of the workforce. Berlin's move to pull out of the state-level association affected only those employees who were employed by the city of Berlin (e.g. administration, childcare, etc.). Those employees in sectors such as waste disposal and local transport, who had originally been the stronghold of militant public sector unionism (Keller 1993), were operating under different privatised agencies and were therefore not affected. Ver.di thus entered a dispute against the Berlin's public employers without its major militant groups. The local struggle was eventually resolved in August 2003. Ver.di had to make greater concessions in the form of reduced individual incomes in exchange for a promise by the state not to impose forced redundancies until 2009 (Dribbusch and Schulten 2007).

At the level of national negotiations, at the same time, Länder and municipal employers in Eastern Germany were voicing loud concerns about the need to reach a moderate pay settlement to ease the burden on their deficit-ridden budgets. While Ver.di reacted positively to the arbitrators' proposal, the public employers adamantly rejected it as too expensive and too much in favour of the unions. A final compromise could be achieved on 10 January 2003 on the basis of some changes vis-à-vis the initial proposals of the arbitrators. The contract included a one-off payment of 7.5% of the salary for March 2003 and a further €50 in November 2004. Furthermore, it was agreed that basic pay would increase by 2.4% as of 1 April 2003, by a further 1% from a January 2004 and another 1% from May 2004. Wage equalisation between the East and the West would be achieved gradually by 31 December 2009. Employees in the East would have to pay

a social security contribution of 2% by the end of full harmonisation. One day-off a year would be cut as of January 2003 (EIRR February 2003). Additionally, the employers and the unions agreed upon reforming/modernizing the legal framework of collective bargaining in the public sector by the end of January 2005.

Ver.di was clearly satisfied with the provisions of the agreement which, regardless of its extremely long duration (27 months) was viewed as a “success”. For the employers, instead, the sealing of the 2002 agreement represented the straw that broke the camel’s back. As a result of the settlement, the cleavage between the federation and the Länder’s employers grew irreversible. The federal level through the Minister of the Interior Otto Schily welcomed the settlement as a “compromise that needed to be tolerated” (WSI Tarifarchiv 2002). The Länder and the municipalities – who bear the bulk of the costs for public personnel – harshly denounced the agreement which they deemed unaffordable for their budgets. The prime ministers in the Eastern States of Saxony-Anhalt, Thuringia and Saxony soon threatened to leave the TdL as a result and suggested they would create their own bargaining association in order to negotiate cheaper settlements. A similar wave of threats emerged among the municipal employers (Behrens 2003). At that point, the very organisations for the representation of States and municipal public employers’ interests in the public sector were under the serious threat of experiencing a mass opt-out of their members.

Thus, a political misalignment within the public employers’ camp could no longer be avoided due to the asymmetric financial burden which public sector wage setting imposes on the different levels of the German administration. Winter 2003 constituted a point-of-non-return for the public employers which grew irremediably divided. At the same time, however, the social partners had jointly committed to overhauling the legal framework of collective bargaining in the public sector by the end of January 2005. So, negotiations were started which lasted throughout the period 2003-2005. The process will reveal arduous and the public employers’ political coalition which had underpinned the former centralised and encompassing wage bargaining in the public sector for forty years will break up.

#### *2003– 2004 – 2005*

The reform of the collective bargaining framework in the public sector had long been in the pipeline. The legal framework had been established in the early 1960s and had hitherto remained largely unchanged. Until 2003, labour relations in the public sector had been fairly cooperative. Differently from the German private sector where sectoral bargain is the norm, public sector collective bargaining had been centralised at the federal level. The three public employers (Interior Minister, TdL and VKA) formed the so-called collective bargaining association (*Tarifgemeinschaft*) and negotiated with the trade unions for which ÖTV (and from 2002 onwards Ver.di) led negotiations and coordinated the demands of the smaller DGB unions. It was already by the mid-1990s,

however, that both the employers and the trade unions had converged on the idea that a fundamental “modernisation” of the system was necessary. There was the need to take into account changes in the labour market and in the financial and economic environment.

After reunification, two crucial factors contributed to undermine the effectiveness and desirability of the old framework. On the one hand, high structural budget deficits at all levels of government constituted a novelty for the stability-oriented German economy. On the other, the process of European integration enhances processes of privatisation and liberalisation of public services. As a result, during the 1990s the old framework centred on the BAT contract came under pressure from different sources which triggered the need for an institutional change.

The pressures to which public sector wage setting was exposed to in the early 2000s cannot be appreciated fully without analysing it against the background of the “macro-politics” of public finance and *the fiscal crisis of the German state* which was taking place at the turn of the century (Streeck 2007). As it has been noted, in fact, by the late 1990s German politics was exposed to a series of simultaneous and compelling fiscal problems which were partly structural and partly path-dependent, i.e. a legacy of the herculean reunification effort. On the one hand, politicians had come under pressure to cut statutory non-wage labour costs and to consolidate public finances under the requirements of the Stability and Growth Pact. On the other, international tax competition urged the need to make the corporate tax system more business friendly while the transition to the knowledge economy suggested the need to increase public investment in education, research and technology. All of these challenges, in one way or the other, required taxpayers’ money and had to be met by the government in a policy environment of weak growth and high unemployment - not least due to the legacy of the Bundesbank’s decision to keep monetary policy exceptionally tight for an extended period of time after reunification.

As already mentioned, in the aftermath of reunification the Kohl government, which had promised not to increase taxation, had shifted a large chunk of the financial costs of supporting the East onto the social security system. In transferring its social policy obligations from the state’s budget to the independent budgets of the four para-fiscal social security funds, the aggregate social security contribution rate increased steadily. But in so doing, the government could avoid raising taxes (Manow and Seils 2000, figure 6.3; Streeck 2007; figures 1 and 3). From 1993 the political debate started to be dominated by concerns that the German economy had lost its international competitiveness due to high social security levies (Poguntke 1994). When in the mid-90s it became clear that high and rising social contributions acted as a brake on employment in the service economy (Scharpf 1997a), from 1996 onwards the government increased again the federal subsidies to the social security system in order to avoid further hikes in the contribution rate. This put pressures on the federal budget and forced both Kohl and Schröder to finally raise some taxes (e.g. a 1% VAT hike in

1997 and the introduction of an eco-tax in 1999) (Streeck 2007). During the period 1990-1997 the general government's deficit run at an average of 3.1% (own calculations from OECD data). This was an unusually excessive level for the German political economy which had approached reunification with a fiscal surplus. Public debt grew by more than 20% of GDP between 1991 and 2003, skyrocketing to more than 64% of GDP from less than 42% (OECD 2004, 34-35). The combination of lower revenues due to weak growth and higher expenditures linked to the social security system led Germany, in the early 2000s, to violate the rules of the Stability and Growth Pact for several years in a row. This even prompted the Ecofin Council to initiate an excessive deficit procedure against Germany when the budget deficit came close to 4% in 2003 (OECD 2008, 52).

At about the same time, with the entry into the fiscal equalisation system of the Eastern Länder in 1995 the deficits of the Western States, which had hitherto suffered only a minor blow, started to come under pressure. The effort to meet the Maastricht's *vincolo esterno* - of which public sector wage restraint had been the central component - had helped to consolidate overall finances. Yet the Schröder tax reform, which aimed at making the corporate tax system more business friendly, eventually induced a collapse in tax revenues which became problematic with the 2001 reform step. This tightened up the public employers' fiscal space. The budgets of the Western Länder were disproportionately hit by the fall in tax revenues and the impossibility to manipulate their own tax revenues through legislation exerted enormous pressures on the expenditures' side. Needless to say, since personnel costs amount to a very substantial proportion of their total outlays (figure 10), the stock of public sector wages had to be the first casualty on the altar of fiscal consolidation.

Mounting deficits, in conjunction with the spread of the NPM mantra and further European integration through the provisions of the single market, propelled trends of privatisations and outsourcing. But these trends affected mostly municipal and federal employers. Since the 1980s, the rise of the European regulatory state (Majone 1994) had imposed on national governments the liberalisation and deregulation of formerly protected public service sectors such as telecommunications, railways, electricity and aviation (Bulfone 2018; Thatcher 2014). This prompted the reorganisation of the German public sector to eliminate political control of domestic firms and let market forces operate in what had to become a European market. The privatisation of the federal postal and telecommunication services and of the German railways moved thousands of previously public employees outside the scope of public sector collective agreements. Many of the new companies which then entered these liberalised markets were often neither signatory of collective agreements nor part of employers' associations (Dribbusch and Schulten 2007, 163).

The spread of NPM affected mostly the local level where measures aimed at "modernizing" the management of local public services (such as local transport, waste disposal, street cleaning, energy supply, etc.) through "market-related concepts and

instruments to save scarce funds and increase public sector efficiency and effectiveness in hard times” (Keller 2011, 2335). Many municipal employers, increasingly in competition with private providers, thus started to establish new companies under private law. Alternatively they started to outsource the provision of public services to private entities. By entering the domain of private law, while pursuing public functions, these entities remained outside the scope of the collective agreements in the public sector. In a context of financial precariousness, and given their incapability to manipulate substantially their revenues, privatisations and outsourcing allowed municipal employers to make savings in labour costs by undercutting the sectoral contract or through massive job cuts altogether (Dribbusch and Schulten 2007).

Dynamics of privatisation and outsourcing of local public services created a second line of segmentation in the public sector workforce which dealt a mighty blow to the trade unions’ power in the public sector. The legal demarcation between civil servants and public employees had always been a constant trait of public sector industrial relations. The fact that civil servants enjoy no right to strike weakens unions’ associational power by legally splitting the workforce between two statuses - one of which cannot undertake industrial action. Since the decision on whether to hire under one legal status or the other is discretionary and depends on the public employer, widespread situations exist (most notably in the education sector) in which civil servants and public employees work side by side. These employees often execute similar functions but are subjected to different legal restrictions. In such contexts, unions’ capacity to mobilise the workforce is severely hampered by the employers’ capacity to “divide and rule”. Privatisations and outsourcing of local services weighted in to shift the balance of power in favour of the public employers because these dynamics “neutralised” the very militant segments of the public workforce.

This created a further legal distinction between public and privately provided services. In fact, the bastions of public sector militancy in Germany have historically been the blue-collar workers in local public services, namely local transport, utilities and waste disposal (Keller 1993). It was on their disproportional disruptive power and mobilisation strength that the public sector trade unions could rely to counteract the prerogatives of public employers. Joint bargaining on the unions’ side had always rested on the informal convention that those were the workers that would engage in strike activity to apply. Thanks to disruptive pressures at the local level, the trade unions would then seal public sector contracts at the central level. This circumscribed strike action at the local would thus benefit the whole public workforce.

German public sector white-collar workers feature instead a traditionally weak associational power and have had to free-ride on the disruptive power of those militant groups at the municipal level. This is partly the case because of their split between two different legal regulations, as explained. Most importantly however this is especially due to a sense of duty and ethos for which public employees, especially those working in the education sector, oppose collective mobilisation (Interview with official in the

top echelon of GEW 2017). These dynamics have, over time, substantially weakened Ver.di's mobilisation capacity. The reason is that, along the lines of the old ÖTV, Ver.di's social base tends to be concentrated among workers at the local level while GEW, due to its concentrated base in the education sector, tends to be stronger at the state level (Interview with officials in the top echelon of ver.di 2017).

As a result of these trends, since the mid-1990s, ÖTV and DAG had worked together to devise a comprehensive restructuring of the collective bargaining framework. In 1994 ÖTV held a special congress which aimed to debate the future of collective bargaining in the public sector. Conscious of the pressures emerging from privatisations, outsourcing, European integration and especially financial problems, ÖTV conceived for the first time the idea of a unified framework agreement for both white and blue-collar workers. In November 2001 the bargaining commission of Ver.di set up the so-called "modernisation commission" in charge of studying a detailed reform plan. In March 2002 the commission proposed to enter negotiations with the public employers and issued a "100-points paper" that would serve as a basis to discuss the status of labour law in the public sector. When the 2002 contract was eventually signed in January 2003, in the contract the parts undertook the formal commitment to proceed ahead with joint negotiations, setting up the objectives and the principles behind the reform. The parts aspired to: increase the efficiency of the public service; introduce elements of performance-related pay; make public services more customer and market oriented; streamline administrative procedures and increase transparency; make the public sector more attractive; eliminate discrimination at the workplace and the distinction between white and blue collar workers (WSI Tarifarchiv 2005).

Overall, the negotiations lasted for around two years until the reform of the bargaining system was eventually achieved in February 2005. But bits and pieces of the old constellation were left behind. Immediately after the signature of the 2002 contract, in May 2003, a "steering committee" composed of representatives of both employers and unions started to meet to discuss the elements of the reform. Yet the working of the committee proceeded in dribs and drabs amidst turbulent conflicts and the unravelling of the employers' *Tarifgemeinschaft*. Within the employers' camp a fundamental vertical cleavage had emerged whereby the Länder no longer saw common ground in bargaining collectively under the leadership of the Interior Minister.

In May 2003 the joint bargaining association among the public employers collapsed. This association had ensured centralised public sector bargaining for half a century, collapsed. The Bavarian Finance Minister Kurt Falthäuser representing TdL announced its dissolution. Furthermore, TdL announced the termination of the collectively agreed provisions on Christmas and summer bonuses in order to renegotiate lower terms. In June TdL quit the conditions of the collective agreements with entry into effect upon the newly-hired from 1 July. Given the disproportionately high personnel costs which Länder employers face, the 2002 contract came under fire among the States' employers. TdL declared that it would no longer accept the traditional leading role of the federal

level where only a tiny minority of all public employees is employed. Next to this, pulling out of the bargaining coalition had the clear advantage for the States that collective bargaining would be disentangled from the municipal employers, i.e. the weak chain within the employers' camp. Getting rid of the local level in negotiations was for the TdL a strategic move to break free from the municipal workers' capacity to affect overall wage negotiations through their disruptive power in local infrastructural services.

In truth, the *Tarifgemeinschaft* had already started to crumble even before the 2002 pay settlement was reached when Berlin had withdrawn from its membership in the VKA and the Association of Employers' Public service (*VadÖD*). This Länder-level subsidiary association, which was created after Berlin had been expelled from TdL in 1993, was included in the employers' joint negotiations alongside TdL. Berlin resigned from its membership. The January agreement eventually led several other Länder and municipal employers to voice concerns about the financial viability of the settlement. When Baden-Württemberg, Hessen and Saxony threatened to leave the Länder employers' organisation due to the high costs of the contracts, TdL itself came under a very existential threat. TdL's exit was a due action in the course of saving the horizontal wage coordination among the Länder employers. In fact, the move was driven by the financial interests of Länder employers which were united across the party-spectrum. TdL's exit from the employers' bargaining coalition was welcomed unanimously by both SPD- and CDU-led States (Dribbusch 2003).

Until March 2004, however, the three public employers continued to negotiate together on the institutional reforms with the trade unions. The rupture point came when the conflict on weekly working hours escalated. To extract further savings, all Länder employers, regardless of their political complexion, had been extending the weekly working week for their civil servants from 38.5 to 40 hours, inducing the federal government to follow suit at the end of 2003. On grounds of "equal treatment" Länder employers demanded public employees alike be subjected to a longer working week (Dribbusch and Schulten 2007, 170). The row over longer working hours escalated first in the state of Hessen in mid-December 2003, leading its CDU prime minister Roland Koch to take the state out of the TdL. Hessen's authorities wanted public employees to work longer than the collectively agreed provision of 38.5 hours, in order to align their working week to that of the civil servants' - which had been extended to between 40 and 42 hours, starting from January 2004. In so doing, the employers tried to force Ver.di into negotiating on the issue but the union, for fear of jeopardizing the whole working time provisions, refused. Koch took Hessen out of the TdL with the hope to force Ver.di to renegotiate a separate agreement. In so doing, he went on justifying his decision to leave the employers' association on the grounds that the January 2003 contract was too expensive (EIRR January 2004).

When also other federal States started to demand a longer working week be applied to the newly-hired employees TdL, to prevent an internal haemorrhage, was forced to

renege on the collective agreements on working time for white- and blue-collar workers in West Germany (Interview with official in the top echelon of TdL 2017). At the end of March 2004, TdL quit the agreements on working time with immediate entry into effect from 1 April. The Bavarian prime minister Edmund Stoiber welcomed the move while the federal Minister of the Interior Otto Schily deplored the States' decision (Zschaler 2004b). Ver.di's leadership started to fear that collective bargaining in the public sector would collapse fully and a fragmented and unmanageable bargaining scenario would emerge (Dribbusch 2005). Yet Ver.di could not tolerate the behaviour in the breach of the 2003 legal agreement and suspended the joint negotiations for the reform of the bargaining system. With TdL withdrawing from negotiations altogether, talks resumed only between Ver.di and the municipal and federal employers from the beginning of April. From then onwards, Ver.di would be engaged on two fronts. On the one hand, relations with the Länder employers became increasingly combative on the issue of working hours' extension. On the other, Ver.di was negotiating the overhaul of the bargaining system's legal framework with the federal and municipal employers - which it wanted to keep together to avoid the full fragmentation of the system.

The steering group on the reforms resumed its work in May 2004 and met for around 15 times before arriving at the preliminary draft of the reform of the bargaining system in early January 2005 (WSI Tarifarchiv 2005). In the meantime, in November 2004, the federal Finance Minister Hans Eichel had announced that the federal government would be seeking a zero wage bargaining round for the new contract to be agreed before 31<sup>st</sup> January 2005. In his announcement he enjoyed the support of the opposition and the business community. Weakened by the split among the public employers, Ver.di signalled its willingness to negotiate on a zero wage round in exchange for the introduction of the new pay system in the public sector - which it wanted at all costs (Interview with officials in the top echelon of ver.di 2017). The government was also keen on introducing the new system. However, the government made clear that the reform would happen only under the condition that it be introduced on a cost-neutral basis (EIRR December 2004). After all, the government was under the Commission's radar for breaching the deficit ceiling of the Stability and Growth Pact. In early December, along the same lines, also TdL announced its intention to pursue a "zero" wage round (General-Anzeiger 2004).

After two years of turbulent preparations, on 9<sup>th</sup> February 2005, Ver.di and the federal and municipal employers reached a compromise and the new TVöD system was born. The new legal framework for collective bargaining in the public sector would cover around 2.1 million public employees in between the federal and municipal levels. In providing for the sought-after modernisation of the bargaining structure, the agreement envisaged a transition period of three years according to which the collectively agreed provisions would be valid between October 2005 and the end of 2007.

In terms of pay improvements, the unions forewent percentage increases altogether and accepted instead lump sums for the following three years (35 months to be precise).

Accordingly, all employees received a €300 lump sum per year in 2005, 2006 and 2007. The wages of municipal workers and trainees in Eastern Germany were to be adjusted to Western levels by 1.5% a year in 2005, 2006 and 2007. In line with the TV-V contract signed at the municipal level in 1999, the accord eliminated the legal distinction between white- and blue-collar workers in the public sector, thus providing for a new harmonised pay scale for all employees. The new scale contains 15 vertical categories of employees and 6 horizontal pay grades. The entry pay level at the bottom of the new pay scale was reduced, upon request of the unions, to make the public sector more competitive vis-à-vis privately provided services. This was meant to contain the trend of privatisation and outsourcing of public services. With the lowest wage rate for low skilled workers now set at € 1.286 a month in Western Germany and €1.209 in Eastern Germany, the new public sector entry level was about €300 lower than before, a substantial undercut. An element of performance-related pay was inserted in that bonuses (up to 8% of the salary) formerly based on age and family responsibilities were, from 2007 onwards, to be handed out on the basis of performance. The Christmas and summer bonuses were merged into one payment which, starting from 2007, would be equivalent to between 60% (for employees in higher pay scales 13-15) and 90% (for employees in lower pay scales 1-8) of the monthly salary - a substantial cut in relation to the two previous instalments.

As for working hours, the federal employees' working week was set at 39 hours, while an opening clause was agreed for municipal employees whereby the parts would be able, in the future, to negotiate locally working weeks up to 40 hours. Lastly, a crucial element which made the agreement possible was the inclusion of a so-called "most beneficial clause" (*Meistbegünstigungsklausel*). Upon request of the federal employers, it was agreed that in case more-employer-friendly terms than those signed in the TVöD contract would be agreed in future negotiations with TdL or VKA, those terms proven to be more beneficial to the employers will be automatically translated in the TVöD as well (Dribbusch 2005; EIRR March 2005; WSI Tarifarchiv 2005).

Although for Ver.di the reform unequivocally amounted to a *reformatio in peius*,<sup>26</sup> the unions contented themselves with a compromise achieved under adverse external conditions. Faced with the disintegration of the public employers' camp, Ver.di's success rested on keeping the employers as compact as possible. The alternative fragmented landscape which was to ensue without the TVöD contract would have been unmanageable for the unions. While remaining firmly against the extension of working hours, the unions rather unanimously welcomed the deal even though it was admittedly a concessionary bargain.

To use the words of officials in the top echelon of Ver.di:

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<sup>26</sup> The new TVöD system is considerably cheaper for the public employers. For a comparison between the old BAT and the new TVöD systems see EIRR (May 2005) and Keller (2011).

*“(The problem was that employers would leave the BAT because they deemed it too costly and too complex, but Ver.di wanted to preserve the framework of collective wage negotiations. Accepting TVöD was the price to pay to keep the employers within their organisations. The alternative, (i.e.) to negotiate with individual employers, would be too difficult to engage with” (Interview with officials in the top echelon of ver.di 2017).*

The problem for Ver.di was particularly acute at the local level vis-à-vis municipal employers.

*“The (TVöD) reform was triggered by privatisation because when private services started to pay lower wages, unions in the public sector had to react. There it started a competition with private organisations which offered lower prices. VKA was very important in this process. So was Ver.di which has most of its members at the municipal level. VKA had to compete with private services and was undergoing a process of erosion because public enterprises started to pull out of the organisation and get their contracts outside VKA. Ver.di had to face the fact that the VKA was losing its members. Ver.di and even we (dbb) realised that we had to change our politics. We would have liked to go on as we always did, but if we did so, the VKA would have become a weak partner, but we wanted to keep the VKA strong and so we declared our willingness to change the bargaining system: if VKA loses its members, Ver.di will lose a partner they need. The TVöD introduced a lower group which gave the VKA the opportunity to compete with private organisations. We wanted to maintain the system but in order to maintain it, we had to change it” (interview with official in the top echelon of dbb's Tarifbericht 2017)*

Thus, at this historical juncture, the serious cleavage among the employers ended up disempowering the unions. To manage collective bargaining in the public sector, Ver.di depended on keeping the employers together as much as possible more than the employers themselves would have wished to remain together. In fact, they did not. Due to different material interests rooted in the asymmetric stocks of personnel costs with which they are confronted, the public employers had split and the full disintegration of collective bargaining in the public sector was indeed a possible scenario to be taken into account. The Finance Minister Eichel cheered the fact that “the low pay increases will provide further economic stability” (EIRR March 2005). The VKA boasted the introduction of performance-related pay and, above all, the much cheaper pay provision for the unskilled workers at the bottom of the pay scale (Dribbusch 2005).

Sealing the TVöD closed up one of the tables in which Ver.di had been kept busy for two years. But the parallel controversy with the Länder employers still needed to be solved. After the TVöD agreement, Ver.di tried in vain to convince TdL to take on board its results. Speaking for the TdL, the CDU Finance Minister of Lower Saxony, Hartmut Möllring, rejected the offer. Two were the bones of contentions. States were unsatisfied with the regulation of working hours, which they wanted to extend and with the regulation of the Christmas and summer bonuses, which they wanted to reduce further. Secondly, and most importantly, they deemed the TVöD still too expansive for the dire budgets of the States (WSI Tarifarchiv 2005). Amidst unions' warning strikes staged against TdL's working time policy, Ver.di and the TdL entered negotiations on a

new collective bargaining framework for the Länder in spring 2005. A compromise would not be reached until the second half of May 2006.

2006

Two legal clauses which had been inserted in the TVöD made the constellation in which Ver.di had to negotiate with TdL very complex. These clauses constrained Ver.di's action space. Additionally, the union had again to fight on multiple tables, five to be precise. As a result of the multiple fronts open, the environment became increasingly combative throughout spring 2005 and the summer of 2006.

In negotiations with the TdL, Ver.di wanted the Länder employers to adopt similar provisions than those agreed in the TVöD. However, TdL did not second Ver.di's desire and firmly aspired to extend the weekly working week. The adoption of the "most favourable clause" in the TVöD brought about the necessity for Ver.di not to cave in against the Länder employers' offensive. In fact, had Ver.di accepted an extension of the working hours (which it strongly opposed) at the Länder or municipal level, this provision would have been lawfully transposed in the TVöD contract as well. Simultaneously, the adoption of the "opening clause" on working-hours regulations at the municipal level induced local employers in various States to try to extend the working week beyond the 38.5 provision of the TVöD. Ver.di tried hard to fight back. Conflicts on the working-hours regulation emerged especially in the States of Baden-Württemberg, Hamburg and Lower Saxony where the municipal employers all argued longer working weeks be necessary to cope with their budget constraints (Dribbusch 2006).

The first battlefield was in Baden-Württemberg and concerned employees working in local health clinics. In summer 2004, the university hospitals (*Unikliniken*) had withdrawn from the employers' association and aimed at increasing the working week up to 40 hours for the newly-hired, a desire which Ver.di opposed strongly. When five consecutive negotiations failed, in October 2005 the union coordinated a warning strike which involved around 20.000 workers. After one week and a half of strikes, a compromise was reached which set the point of reference for the following agreements. A differentiated treatment was agreed. Instead of 40 hours, employees below the age of forty would work 39 hours, those in between forty and fifty-five years old would work 38.5 and older workers would work 38 hours per week (WSI Tarifarchiv 2006).

At about the same time another struggle ensued in Lower Saxony where the municipal employers decided to quit the working time provisions of the TVöD as of beginning of December 2005. Negotiations were tried in vain and strikes began until a compromise could be found in mid-March 2006. The deal established a 39-hour working week with the exception of childcare facilities, hospitals and the employees in the capital administration where the working week remained at 38.5 hours.

Similar developments occurred in Hamburg where the failure of initial negotiations between Ver.di and the Hamburg's employer association (*Arbeitsrechtlichen Vereinigung Hamburg, AVH*) eventually was overcome with an agreement similar to that stipulated in Baden-Württemberg. Working hours were decided on a differentiated manner on the basis of employees' age, remuneration and family composition. The Hamburg agreement however was not regarded as a pilot agreement for the other ensuing disputes.

The last two controversies in spring 2006 were the harshest for Ver.di. On the one side a further controversy took place vis-à-vis Baden-Württemberg's municipal employers (KAV). On the other, Ver.di was simultaneously engaged in talks with TdL to renew the collective bargaining framework. Conflicts in Baden-Württemberg were the hardest because the KVA employers had no intention whatsoever to compromise. Municipal employers there had already terminated working-time regulations in October 2005 and had extended the working week up to 41 hours, had cut holiday pay and had reduced the Christmas bonus (EIRR January 2006). Given the failure of negotiations, strikes began in early February and protests were carried on for nine consecutive weeks, seriously disrupting local services after attempts at conciliation failed. It was only after the fifth attempt that, in early April, the parts reached an agreement on the 39-hour working week without differentiations.

In the meantime disputes continued at the state level between Ver.di and TdL. The parts had started official negotiations in mid-april 2005. Due to the lack of progress, Ver.di staged strikes in mid-february 2006 but TdL's Hartmut Möllring, Finance Minister of Lower Saxony, intended to hold out against the unions' industrial action. "The finances of the regional authorities", he argued, "are in such a mess that a lengthening of the working week would be justified" (EIRR February 2006). TdL intended to introduce a 40-hour working week. Ver.di, however, needed necessarily to prevent this from happening otherwise, through the "most beneficial clause", the same extension would have automatically been adopted in the TVöD, taking the working week up to 40 hours also at the federal and municipal level.

Top-level discussions continued in between late February and early March. When the parts met again on 10 March, Ver.di put a compromise on the table. Along the lines of the agreement which had been reached at the local level in Lower Saxony, Ver.di suggested to differentiate the regulation of working hours. Differently from that deal, however, Ver.di recommended the criterion be based on pay grades rather than age. Lower pay grades (1-10) would have a 38.5-hour working week which would gradually increase to a 40-hour week approaching the pay grade fifteen. Ver.di also offered concessions on the summer and Christmas bonus. Yet the package was rejected by TdL as insufficient. Strikes continued throughout March, April and May in what became the hardest dispute in public sector wage setting since 1992 (EIRR April 2006; Keller 2017).

Eventually, on 20 May 2006, after 16 weeks of industrial action an agreement was reached and the TV-L bargaining framework for Länder's employees was given birth (WSI Tarifarchiv 2006). Negotiators were faced with a trade-off between whether to compromise and getting over the impasse or kick the can down the road and face the disruptive effects of a paralysis of the system. As common in the German model of capitalism, they compromised – settling the dispute on working hours on the basis of an average provision. The new TV-L collective agreement applied to all the States but Hessen and Berlin. The latter then re-entered the TdL in 2012.

The agreement covered the period from 1 November 2006 to 31 December 2009. In terms of pay, similar to the TVöD, different lump sums were granted until September 2007 which differed on the basis of income groups. The lowest grades (1-8) received €150 in July 2006, €310 in January 2007 and €450 in September 2007. The pay grades in the middle of the scale (9-12) obtained during the same period €100, €210 and €300. The higher ranks (13-15) got €50, € 60 and €100. After September 2007 all employees obtained a 2.9% pay increase for the year 2008. These improvements, however, followed after the decision to impose eleven “zero months” from February to December 2005. Like in the TVöD, the distinction between white- and blue-collar workers was eliminated and a 15-grade pay scale was introduced. Also, a similar element of performance-related pay was inserted. A sum equivalent to 1% of the monthly pay was to be paid out according to performance and this provision was set to increase gradually up to 8% over time. Working hours, the bone of contention which had led to a stalemate in negotiations, were set differently for Eastern and Western Germany. In the former, the working week was fixed at 40 hours. In Western Germany the working week for Länder's employees, coming into effect from 1 November 2006, was to be set by each state on the basis of the average of actual and collectively agreed working time in that state. This provision was adopted so that the working week of States' employees would be set in each state as an average of the hours worked by all the other public employees in that state, regardless of the administrative level in which they were employed. In so doing, a “lowest common denominator” agreement could be found through which the TVöD's “most beneficial clause” was circumvented. This solution prevented it from springing into action and, at least in this respect, Ver.di was successful in avoiding the further extension of the working week at the federal and municipal level.

So far, the historical reconstruction has covered developments in the collective bargaining arena through which public employees are regulated. In parallel to the described process of institutional change of the hitherto centralised wage bargaining system, an overhaul of legislative competences concerning civil servants' pay occurred through a process of constitutional reform. These two processes unfolded in parallel, although in different political arenas. Reconstructing the process of constitutional reforms of the civil service's wage determination is the substance of the following sub-section.

## 7.2 COMPETITIVE FEDERALISM AND CIVIL SERVICE'S WAGE DIFFERENTIATION IN THE CONTEXT OF CONSTITUTIONAL REFORMS

With reunification, some 2.2 million public servants from the former GDR had to join the public sector of the unified Germany. Public employees of the former GDR were transferred to the Eastern Länder and their municipalities as provided by art.13 of the unification treaty. As a result, municipalities in Eastern Germany were often overstaffed when compared to their Western counterparts. This oversized public sector was immediately meant to be reduced drastically. The unification treaty contained a controversial clause on the so-called “waiting loop” (*Warteschleife*) which temporarily exempted Eastern public employees from the coverage of Western Germany’s legislation on unfair collective dismissals. Those public employees whose units were closed or reorganised were temporarily suspended for a period of six months during which they continued to receive 70% of their previous salary before becoming unemployed. The legality of this decision was challenged by the former GDR workers before the Federal Constitutional Court. When the court upheld the decision to suspend some hundreds of thousands (between 300.000 and 600.000) of public employees (EIRR May 1991), this paved the way to a substantial downscaling of the German public sector (figure 11).

The bulk of the dismissals occurred between 1991 and 1992 and civil servants’ political affiliation with the old communist regime was often a reason to get the sack (Keller 1999). Since reunification, state and municipal employers in the Eastern part of the country have been reluctant to hire their personnel under the legal status of Beamte, filling their ranks mostly with salaried employees. Throughout the 1990s, due to budgetary problems, public employers in both the West and East made a significant effort to restructure the public sector. Cutbacks were particularly dramatic in the Eastern Länder where public employment was reduced by ¼ while that of Eastern municipalities more than halved (Kuhlmann and Röber 2004). Next to this quantitative restructuring, new regulations providing for the modernisation of the civil service were enacted. In 1997 the civil service reform law provided the Länder with better opportunities for the delegation of responsibilities, downgrading and transfer of staff across different administrations. The law also introduced part-time and more flexible forms of employment for civil servants, together with the introduction of financial incentives and elements of performance pay.

But the most fundamental proposal for an overhaul of the German civil service came from the left in the state of North Rhine-Westphalia, in the early 2000s. Under the leadership of the SPD state premier Peer Steinbrück, the NRW government set up a commission on “the future of the public sector” chaired by Hamburg constitutional lawyer Hans Peter Bull, himself an SPD figure.

As things went:

*“(T)he establishment of the Government Commission took place in the context of a debate on the modernisation of the administration that had been intensively conducted in NRW since the mid-1990s and which, in terms of its "history of ideas", was in turn a reaction to NPM and the idea of the "lean state" ... Of course - and above all - the debate was based on the "crisis of public budgets" that was perceived nationwide at the time" ... At the time, the financial situation of the Länder and municipalities was rather poor - ultimately insufficient for the diversity of the tasks they are charged with - and uncertain. Therefore, the state governments - and to a lesser extent the federal government - had to plan for savings. However, the NRW state government, like other state governments, did not want to make these necessary cuts without a plan ... but on the basis of a systematic analysis of the tasks of the administration ... and the working conditions of the employees and in connection with the ... "internal modernisation". Another motive for the government commission's review of the employment law was its - still existing - dual nature, i.e. the division into civil servants' and collective bargaining law with the consequence that often employees with the same tasks had different legal status and in particular were paid differently and that the personnel administrations had to - and must - work with two different, in each case highly complicated, sets of rules.” (Interview with high profile officials of the NRW Government's Commission on "the future of the public sector" led by Han Peter Bull 2019)*

In early 2003, the commission reported on its findings. A key problem of the German civil service, it was noted, was the costs of its pensions' provisions. Since public employers in the short run do not have to set aside money to pay civil servants' social contributions (pensions are then paid out of the public coffers upon retirement), the system had incentivised an oversized civil service. “Cheaper” *Beamte* were extensively recruited during the 1960s and 1970s and, since the corresponding financial reserves had not been set aside over time, a hidden “multi-billion” bill will have to be footed by future generations. The commission recommended a restructuring of the pension system on the basis of two pillars, a statutory pension scheme and an additional tax-funded pillar (Stuttgarter Zeitung 2003). The commission went on recommending the elimination of the civil servant status for all those employees working in occupations beyond the core functions of the state (police, judiciary, tax collection, external security). The commission thus proposed to overcome the two parallel regulatory systems and create a uniform legal framework of public sector employment relations. The German public sector, it was acknowledged, needed more elements of competition, an orientation toward citizens' needs and more performance-related pay.

On the basis of the commission's proceedings, in spring 2003, Steinbrück called for the termination of the civil servant status of public employment through an amendment of the German Basic Law. At the same time, the NRW government announced cuts in holiday pay and Christmas bonuses for civil servants in view of the “empty public coffers”. The abolition of the civil service immediately became a divisive issue in which political personalities from the Länder became rather vocal. A group of reformist SPD parliamentarians led by the deputy education minister Christoph Matschie called for the abolition of the civil service in line with the Commission's proposals. The greens aligned behind Steinbrück's plan (Keinhorst 2003). At the other side of the spectrum, both the CDU and the CSU vocally opposed the abolition of the *Beamte*

status. Hartmut Möllring, the CDU Finance Minister of Lower Saxony, rebuked the proposal arguing that the German civil service was “irreplaceable”. Overall:

*“the SPD and the Greens tended to favour the creation of a uniform right of employment, as the DGB and some of its member unions had long demanded. The FDP, on the other hand, which is close to industry and should have supported the abolition of the special regulations for civil servants for other reasons, vehemently represented the interests of the civil servants in their special status in this discussion as ever and still today - probably due to by the social composition of their membership, to which many civil servants belonged. The CDU was also on the side of the opponents of reform.” (Interview with high profile officials of the NRW Government's Commission on "the future of the public sector" led by Han Peter Bull 2019)*

On the unions' side, dbb's chairman Peter Heesen called for a reformist strategy that, while preserving the *Beamte* status, would allow the introduction of performance-related evaluations and pay together with a system of sanctions for under-performing civil servants (FinancialTimes 2004). At the yearly meeting of the dbb, in January 2004, the Interior Minister Otto Schily came out in favour of maintaining the civil service. The NRW government aimed to start a legislative initiative to amend the constitution in the Bundesrat by the summer. However, it soon realised that the majority in the upper chamber needed for a such a constitutional change was out of sight (FRIGELJ). The dbb, with the greatest stake in the game, strongly opposed the abolition of the civil service and actively tried to slow down legislative initiatives. Peter Heesen started to engage in high profile lobbying activities. The conditions for a political alignment between the dbb and the Minister of the Interior emerged. Both Heesen and Schily had agreed on the introduction of elements of performance in the civil service. Indeed, both agreed that a major reform was needed. Yet both opposed constitutional amendments and the abolition of the civil service altogether. At this point, the dbb's chairman became the key actor in the process.

The Länder employers were on the offensive from two sides. On the one hand, through TdL they had pulled out of the wage bargaining coalition with municipal and federal employers just to go on their own squeezing the financial costs of collective bargaining for the public employees. On the other hand, they had begun to extend civil servants' weekly working hours and cut summer and Christmas bonuses. When proposals to even eliminate the civil service emerged, it became clear to the dbb that it should have taken a proactive stance to contain the Länder employers' offensive. Heesen approached the Interior Minister Schily with a plan to set forth a reform plan that would “modernise” the civil service without eliminating it from the constitution. Since the beginning of 2004, the dbb and the Ministry of the Interior negotiated together on the cornerstones of a reform plan which was eventually formalised with the publication of a “key-points paper” in early October 2004 (Thiede 2004). The paper was the result of a tripartite agreement between the dbb, the Ministry of the Interior and Ver.di. It carried the signatures of Heesen, Schily and Ver.di's chairman Frank Bsirske. While Ver.di had not been involved in negotiations from the beginning it then joined the process at a later stage in what led to the realignment between the two competing unions. In fact:

*“in the 1990s the relationship between ÖTV and dbb was confrontational and competitive. In the 2000s dbb and Ver.di came together in the two parallel processes of reform” (Interview with official in the top echelon of dbb 2017).*

In the process of reform of the civil service,

*“the dbb was the key player. Ver.di approached the dbb and there was a realignment between the two unions: Ver.di made the dbb part of the TVöD reform and the dbb made Ver.di part of the Beamtenrecht reform.” (interview with official in the top echelon of dbb's Tarifbericht 2017)*

The paper proposed the introduction of an element of performance-related pay in civil servants' salaries (up to 8%). The element of variable pay was meant to “increase responsibility and motivation in the civil service” by eliminating automatic upgrades based on seniority. Due to budget constraints, Schily stressed the need for the reform to occur on a cost-neutral basis and proposed that a draft bill be prepared at the beginning of 2005 in coordination with the federal government and the Länder. Schily hoped to have the reform of the civil service enacted by 2007. Both Bsirske and Heesen boasted the concerted agreement in that the reform would eventually make “amendments to the basic law superfluous” and “avoid the elimination of constitutional protection of the status of civil servant” (AFP 2004). In the minds of the reformers this was the way to proceed in order to strike a balance between the need to reform – which the unions acknowledged - and the request to avoid the elimination of the civil service – for which the NRW state government was pushing for.

However, there were contrasting voices within the Länder employers and within the SPD. A further political cleavage emerged. Talks on the reform of the civil service were taking place against the background of the working of the commission on the federalism reform. The two processes became intertwined when rumours spread that the Länder were planning to claim back the legislative competence for the regulation of Länder civil servants' pay (*Beamtenbesoldung Kompetenz*). In fact, a 32-member commission had been set up in 2003 with the aim to reform the German constitution in order to curtail the Bundesrat's legislative veto power. It had been estimated that the Bundesrat could veto 60% of all the bills. This was deemed excessive and often cause of political stalemate. The federalism commission - composed by members of the two chambers and chaired by SPD chairman Franz Müntefering and the CSU state premier of Bavaria Edmund Stoiber – had the task to reduce the Bundesrat's veto power to 40% of all bills (Benoit and Jaklin 2004). Most importantly, in the negotiations of the constitutional reform, among the other things, the two chairmen had converged on the necessity for the States to claim back the legislative competence on civil servants' pay.

It was not by coincidence that the concerted reform plan by Heesen, Bsirske and Schily had been published right in anticipation of the federalism commission's last meetings in Berlin, in mid-October. By then, three blocs had emerged which cut across and within political parties. On the extremist side, Peer Steinbrück supported by a group of reformist SPD parliamentarians was vocally advocating for the elimination of the civil

service and the introduction of homogenous public sector employment relations regulated via collective bargaining. The “magic trio” composed by the dbb, Ver.di and the SPD Minister of the Interior Schily wanted to struck a reformist mid-way, with performance-oriented reforms within the framework of the civil service. The “big States” in the federalism commission led by Stoiber and Müntefering wanted to maintain the civil service but transfer legislative competences on civil servants’ pay back to the Länder in order to obtain more freedom and flexibility in the management of their own civil servants.

The SPD was internally divided on how to proceed. Schily was against the abolition of the civil service and against the transferal of legislative competencies away from his ministry. The dbb was against the abolition of the civil service and against the transferal of legislative competencies to the States because this would have jeopardised the civil service (with 17 different regulations across the nation) and injected an element of competitive federalism (Zschaler 2004a). With the reform proposal, the unions and the Interior Ministry had hoped that, by offering the possibility to deviate by 8% (-4% and +4%) on federal legislation on civil servants’ pay on the basis of performance assessments, they would have granted the States the sort of “opening clause” that would have dissuaded them to pursue the decentralisation of the *Beamtenbesoldung Kompetenz* through the federalism reform. Yet Müntefering and Stoiber were far apart from the trio’s proposal. After all, what the Interior Ministry was offering the possibility to save money by minor undercuts to Federation-mandated statutory pay, i.e. the possibility to derogate *in peius* vis-à-vis federal legislation on civil servants’ pay. What the richer States wanted instead was the very legislative competence so as to go on their own. Both Stoiber and Müntefering had agreed that the competence was crucial for the restructuring of the States’ budgets. “Otto and I are far apart here”, Müntefering argued when publicly dismissing the moderate reform proposal of his fellow SPD colleague and Interior Minister Schily (Der Spiegel 2004).

To the good hopes of both Heesen and Schily, there was a last minute disagreement in the federalism commission and attempts to reform the German political system collapsed in mid-December 2004. After compromises had been struck on about every aspect of the reform, an unmanageable disagreement emerged on responsibilities for school and university education. The federal government insisted it wanted a greater role to ensure better standards across the country. The States firmly rejected what they perceived as the government’s attempt to centralise control of education policy and redraw the balance of power between the two state levels (Williamson 2004). Reinvigorated by the failure of the federalism commission, Schily and Heesen immediately called on the Länder authorities to now support their concerted reform plan. “The temporary failure of the federalism reform should be used by all parties to reconsider their positions”, Schily argued at the customary January conference of the dbb (Schiermeyer 2005). Indeed, in agreement with the dbb, during spring of 2005 the Interior Ministry stepped up the preparation of a draft law modelled on their previous

“key-points paper” which it intended to publish at the end of May 2005 (Frankfurter Rundschau 2005). Yet Schily’s reformist plan had to be paused again when, in the NRW June elections, the tide turned against the Schröder government and early federal elections were subsequently announced. When it became clear that the SPD had lost support in its traditional stronghold, SPD’s chairman Müntefering announced that the Chancellor would seek early Bundestag elections. At the September elections, all parties but the FDP suffered losses of vote. This notwithstanding, the liberals ended up in opposition and a grand-coalition between the SPD and the CDU/CSU led by Angela Merkel was formed and took office in November (Poguntke 2006).

The issue of revamping Germany’s federal system had earned its way into the coalitional agreement between the SPD and the CDU/CSU (Williamson 2005). Moreover, the grand-coalition now commanded the 2/3 majority necessary to amend the constitution in the Bundesrat. When it became clear that the reform of the German federalism would go through within the newly emerged political constellation, at the end of 2005, Schily abandoned its concerted action with the unions and engaged in horse-trading to make the best out of the constitutional reform. When in November the federal government gave up on the controversial issue of legislative powers in education, the root cause of the previous commission’s failure disappeared. The talks on federalism reform could now resume. Again, the States claimed back the legislative competence on civil servants’ pay. Shily agreed to let the competence go. In return, however, Shily obtained that Federal Criminal Police Office – an executive agency of the Interior Ministry - be given extensive powers of action in matters related to internal defence vis-à-vis international terrorism. In the event, in pursuing the interests of his ministry, Schily bargained one competence for the other, luring for himself the vehement criticism of both the dbb and the DGB (Bonn General-Anzeiger 2005).

Federalism reform I took place in the summer of 2006 and the legislative competences to regulate civil servants’ careers and pay were transferred to the States. Ever since, several developments have occurred. On the careers, while in 2006 the same federal regulations applied, three different state-clusters have now emerged in which heterogeneous career systems apply. The Northern coastal Länder (Bremen, Hamburg, Mecklenburg-Western Pomerania, Lower Saxony, Schleswig-Holstein) have similar systems. Three Länder (Berlin, Saxony, Saxony-Anhalt) have opted for the adoption of parts of the coastal Länder’s model, although with some modifications. All the others have instead opted for highly differentiated laws. This has led, unsurprisingly, to a fragmented legal landscape. The explanation for this development has been attributed to competition for civil servants among States and with the private sector in local labour markets within States (Dose and Reus 2016). With regard to civil servants’ pay, a cleavage has emerged between the highest-paying state (Bavaria) and the lowest-paying state (Berlin). It has been assessed, for instance, that in 2016 the difference in yearly pay between a first-grade high school teacher in Bavaria and one in Berlin amounted to €6,336 a pay difference of 11.3% (DGB 2016, 13).

Overall, with the federalism reform I a layer of competition has been inserted within Germany's cooperative federal system. The new decentralised system of civil servants' pay which has resulted is now a highly fragmented one where those who can afford more, pay more and have less problems recruiting a skilled workforce. Länder are now competing against each other. Working with an econometric model which included partisan political control of the Länder, Dose and Wolfes (2016) find that CDU and CSU Länder governments tend to pay slightly better than governments dominated by left-wing/green governments. However, party politics is not the key explanatory factor for these horizontal wage differentials. Most of the variance across States, they argue, is explained by the ratio of Länder debt to GDP. Thus, given that personnel costs are major expenditures for the Länder, public employers with high budget deficits are most urgently in need to control the financial burden of their civil servants' pay. A full-fledged race to the bottom is however prevented by the necessity of States' public employers to recruit qualified personnel in local tight labour markets. This shall ensure wages do not excessively lag behind developments in the private economy but it does not guarantee the further divergence between richer and poorer States.

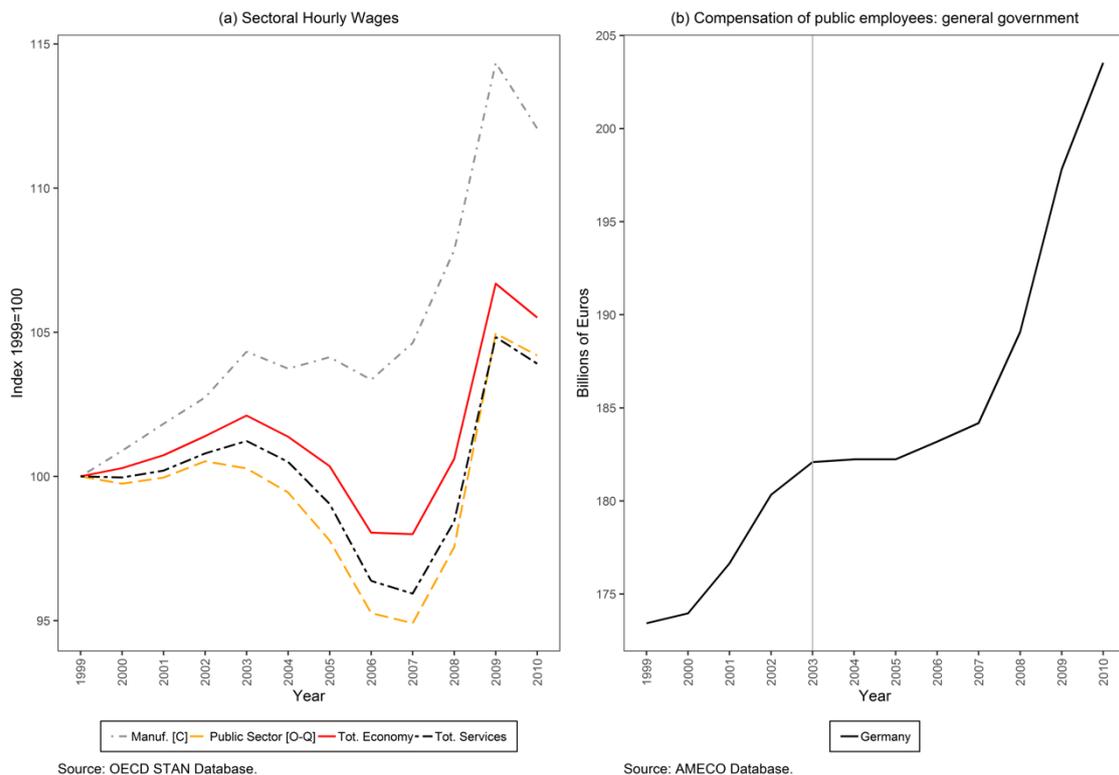
The recruitment problem for Länder employers across Germany is unequally distributed. Richer States where local labour markets also feature lower unemployment rates experience higher recruitment difficulties in competition with the private sector. As a result, they experience stronger upward pressures in civil servants' pay (Dose and Reus 2016). Through the decentralisation of the legislative competence at the Länder level, a valuable flexibility valve has been engineered for richer employers (those who can pay) to remain competitive recruiters vis-à-vis the private sector. In fact, the possibility to independently manipulate pay and career conditions of civil servants *de facto* guarantees to the Länder the possibility to derogate *in melius* vis-à-vis the employment and pay conditions agreed for public employees within the context of horizontally coordinated wage bargaining across the Länder in the TV-L contract.

This, I argue, is a crucial component of the new institutional equilibrium which has emerged in the aftermath of the double process of institutional and constitutional reform. After an analysis meant to recap and discuss the developments of the early 2000s, I discuss the features and the logic of this new equilibrium in the next chapter.

### 7.3 ANALYSIS OF THE 2000S

Figure 15 depicts the trajectory of public sector wage setting in Germany during the 2000s. Panel a shows the impressive divergence between the manufacturing sector and other sectors of the German economy. Particularly pronounced is the wage restraint pursued in the public sector during the mid-2000s until the end of the reform process in 2008. Panel b shows that the fiscal costs of public personnel have been frozen throughout.

Figure 15: Trajectory of public sector wage setting in the 2000s



Akin to what could be observed in public sector wage setting during the 1990s, no evidence in support of the “*Ordoliberalism hypothesis*” can be found. Nor could I find evidence in support of the “*export-sector domination hypothesis*”. Likewise, in relation to the “*pattern bargaining hypothesis*”, figure 15 shows the marked decoupling of wage trajectories in the export and public sector. The divergent trajectories of sectoral wages which figure 15 (panel a) shows cannot be explained via the interests of a dominant cross-class coalition in the export sector. Public sector wage restraint in Germany’s 2000s is rather the result of a clear-cut downward fiscal adjustment, of which public sector wage restraint was just one means among others.

In fact, what I could observe instead is that the process of public sector wage setting follows its own separate logics. It unfolds within the contours of the institutional contextualisation of the German state, its sector specific employment relations

structures and most importantly in relation to its public finances. The logics of public sector wage setting during the 2000s were almost entirely detached from those in the export industry. Neither in documents nor in interviews with key policy makers from all sides, could I detect any trace of a mercantilist economic ideology, not to mention the issue of export competitiveness. I could detect no purposeful mercantilist intention to tackle variables such as the REER or the inflation level through public sector wage restraint. Nor seemed these actors interested in the German current account. The primary driver for the actions of public sector's actors was always fiscal in nature. Or, to put it in better terms, the tightening of the public employers' fiscal space and the budget deficits which ensued put enormous pressure on the employers to reduce the fiscal costs of public sector wage setting. This was a time in which Germany was the sick man of the Euro. Its public finances were being constantly monitored by the European Commission for being in breach of the fiscal rules which Germany's Finance Minister himself had so much pressed for, less than a decade earlier. The first and foremost concern of public employers in wage setting – at all levels of the German public administration – had to do with the “*leeren öffentlichen Kassen*” (empty public coffers).

As a result, the public employers became the *protagonists* of a strategy of fiscal devaluation through public sector wage restraint pursued in concomitance with the reform of the overall system for public sector wage determination. The unions tried hard to hold out as *antagonists* against the public employers' offensive; as much as they could. At times they tried to resist, but were pushed back due to their weakness. This weakness was the result of processes of privatisation and outsourcing which had started during the 1990s. Unions' weakness was further enhanced by the very divisions among the employers – whom the unions need to maintain the framework of collective bargaining alive. At others, unions had to compromise *in pejus* against the aggression of the public employers. If anything, actors in the export sector may be thought, in the background, as likely *consenters* of the public employers' need to engineer a fiscal devaluation via public sector wage restraint. By no means it is however possible to infer from what has been observed that the German government purposefully intended to undercut its EMU competitors through a strategic internal fiscal/wage devaluation. The fact that fiscal *cum* public sector wage restraint may have contributed to lower internal demand, lower inflation, a more advantageous REER and current account surpluses in the EMU does not imply that this was the result of an intelligent (beggar-thy-neighbour) design. During the early 2000s, “Germany” was rather occupied with a full-fledged domestic fiscal adjustment, closely monitored by the European Commission. At that specific historical point in time, within the institutional constellation in which governments pursued policy, a strategy of fiscal and wage reflation was simply not a viable option.

When one speaks of “Germany” in the arena of fiscal and public sector wage policy what is neglected is the decentralised nature of the German state and the dispersion of

political authority across both vertical and horizontal dimensions of the German state which Katzenstein so well highlighted in his work. The result of this dispersion is often a shared authority among state actors in the implementation of both fiscal and public sector wage policy. This necessitates coordination. The historical reconstruction of the 2000s teaches us that what characterises the German public employers as state actors is rather their *internal dividedness*. The story of public sector wage restraint in the 2000s is a story about the emergence of an irremediable political cleavage within the public employers' camp. German *governments* grew increasingly far apart from each other during the 2000s. A fundamental *political misalignment* occurred between the Länder on the one hand and the Federation and municipal governments on the other. Public sector wage restraint in the 2000s was pursued under a set of very fortuitous historical conditions. Some of these conditions were path-dependent (i.e. the fiscal costs of reunification), some others were policy-induced (i.e. the Schröder tax reform), some others were structural (i.e. the multiple veto points of the German political system and the vertical imbalances of the German fiscal constitution), some others were beyond the control of the very policy actors (i.e. the Bundesbank's punitive reaction and the prolonged economic recession *cum* budget deficits which this policy brought about).

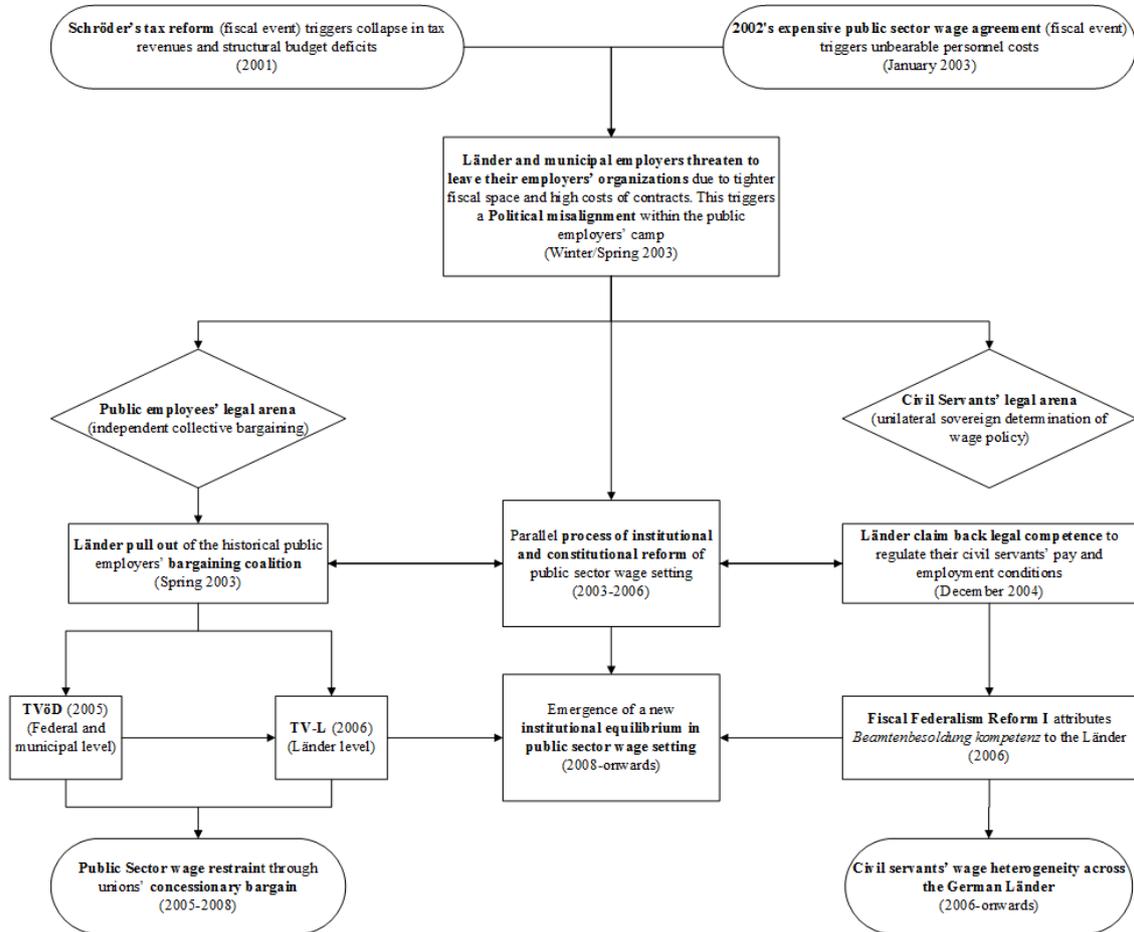
At any rate, the 2000s constitute a watershed moment in the history of public sector industrial relations in Germany in that the reforms which were pursued alongside restraint have institutionalised a new institutional equilibrium, which I discuss in the next chapter. For now, figure 16 provides a diagram visualisation of the sequence of events through which public sector wage restraint was produced in the 2000s. The Red-Green's tax reform implemented by Schröder further aggravated the status of the German public finances, which had already been dealt a blow after the reunification effort. The entry into force of the tax cuts in 2001 constituted the fiscal event which set the causal chain in motion. In a policy environment characterised by weak growth, high unemployment, higher social expenditures and falling tax revenues, the public employers' fiscal space shrunk drastically and so did their ability to pay for personnel costs. About the tax reform it could be said that:

*had the tax reform not been implemented, the finances of the Länder would have not suffered from such a structural fall of tax revenues. Had this have been the case, public employers' ability to pay would have most likely been greater and the need to pursue a severe policy of wage restraint less acute.*

A reduced ability to pay increased the necessity to contain the fiscal costs of public sector wage setting. When the 2002 public sector pay settlement was reached in January 2003 under the leadership of the Interior Minister, this was deemed too expensive by both the Länder and municipal employers. At that point, this constituted the straw that broke the camel's back. Hitherto, collective bargaining in the public sector had been encompassing and centralised under the leadership of the federal level represented by the Ministry of the Interior. A political misalignment occurred during

winter/spring 2003 which led to the internal division of the public employers and the collapse of the historical wage bargaining alliance.

Figure 16: Causal chain of public sector wage restraint during the 2000s



One can appreciate fully the material roots of this cleavage only when considering the peculiarities of the German state's institutional contextualisation. The three institutional domains presented in the analytical framework have concurred to shape public employers' preferences and actions as follows. Due to the structure of the German politico-administrative system and the asymmetric distribution of administrative competences, the bulk of public personnel are employed within sub-national governments. As a result, the Länder face the highest proportion of personnel spending which they have to meet with their own financial resources. Yet, due to the German fiscal constitution whereby tax legislation is a competence of the federal level, the Länder's fiscal autonomy is severely curtailed. This means that States could not manipulate their revenues' flows at will. Germany is indeed very centralised when it comes to tax legislation. This put a serious strain on the Länder's already tight budgets, structurally reducing their ability to pay. Given the enormous weight personnel costs have in their books, the Länder no longer saw common ground in sticking with the

historical bargaining coalition led by the federal level for which personnel costs are only a very minor concern. In fact, given its larger fiscal space and minimal labour costs, the Federation's ability to cope with the financial burden of the 2002 pay provision was greater. Instead, both the Länder and the municipalities deemed it unacceptable.

In the event, Länder and municipal governments threatened to exit their respective employers' associations due to the high costs of centralised bargaining. When it became clear that the Länder governments were serious about opting-out of TdL, in May 2003, TdL's Bavarian Finance Minister Kurt Falthäuser announced the dissolution of the old public employers' *Tarifgemeinschaft*. As a matter of organisational survival, TdL had to leave the old coalition. In fact,

*had TdL not pulled out and fought independently for cheaper settlements at the States' level, state governments would have left – as some of them in fact did or were about to do – the employers' organisation. TdL was confronted with an organisational dilemma as to whether remain in the Tarifgemeinschaft but lose members or to pull out to preserve its very survival outside the Tarifgemeinschaft. The choice to leave is thus perfectly understandable.*

Within the public employers' offensive, Länder governments were the central protagonists. In pulling out and moving to a Länder-only collective bargaining framework eventually agreed upon in 2006 (TV-L), TdL could achieve two substantial goals which enabled the Länder to save money. On the one hand, Länder employers could detach themselves from the expensive leadership of the federal level in wage bargaining. On the other, Länder employers could separate themselves from the disruptive power of militant municipal employees (e.g. local transport, waste disposal) which had always made the municipal employers the weak chain in the *Tarifgemeinschaft*. In the process of fiscal adjustment, the Länder employers attacked *all* aspects of public employees' employment relation. Wage restraint was achieved through multi-year moderate lump sums negotiated with the unions ahead of the signature of the TV-L contract. This explains the flattening of the trajectory of public sector wage growth (figure 7). Working hours, which had been the bone of contention throughout negotiations in 2005 and 2006, were extended on the basis of a compromise. Each Land was allowed to set working hours by taking the average working hours of all public employees in the Land as the benchmark. The various bonuses were merged and reduced. Holiday provisions were cut. As a result of all of these measures, the Länder could substantially reduce their budget deficits and complete their fiscal adjustment (figure 15). Export-sector success was of no interest to the Länder governments.

In parallel and during the same time span, the Länder proactively sought – and managed – to obtain the legal competence for the determination of their own civil servants' careers and pay provisions. To block the transferral of the legal competence from the federal to the Länder level, a political coalition had formed between the dbb, Ver.di and the Interior Ministry Schily. At the same time, some actors led by the

NRW's government were even claiming their intention to eliminate altogether the legal status of civil servant from Germany's constitution. Both dbb's head Peter Heesen and Schily were the key protagonists in trying to block these developments. Heesen and Schily, together with Ver.di's Frank Bsirske formed a "coalition of the moderate". They acknowledged the need to reform the civil service but hoped to preserve it in the constitution in the first place. Also, they opposed the transferral of *Beamtenbesoldung Kompetenz* to the States in order to avoid jeopardising the German civil service across the country. Within the federalism commission which was working on the overhaul of the German federal system, a political coalition of the richer States had emerged which claimed the legislative competence be returned to the States. Both chairmen of the commission, SPD's Franz Müntefering and the CSU state premier of Bavaria Edmund Stoiber were pushing along these lines. After a first attempt to reform the constitution failed at the end of 2004, when the grand coalition came to power a new majority emerged and the success of fiscal federalism reform I came in sight. In the new constellation, Schily gave up on the moderate reform plan and bargained an alternative competence for his ministry before letting the *Beamtenbesoldung Kompetenz* go back to the States.

The third process of the 2000s is the creation of the TVöD contract in 2005. The necessity to reform the collective bargaining structure in the public sector had already been acknowledged by all actors in the course of the 1990s. Most likely, had the Länder not pulled out, the reform would have happened anyway. But it would have not happened in the way it did. The employers would have remained together within the bargaining coalition and restructured the legal framework so as to accommodate the new pressures emerging from dynamics of privatisation, outsourcing and the mounting budget deficits. Yet the States opted-out. Why then did the municipalities remain together with the Federation? Why didn't they go on their own even though they feature very different personnel cost structures (figure 11)? The answer to these questions has three facets. First, as explained, VKA has historically been the weakest among the three employers. Municipal employers depend crucially on the provision of local infrastructural services to the community. This means that municipal employees have a relatively high disruptive power vis-à-vis municipal employers. In wage bargaining negotiations, sticking together with the "bigger brothers" is of convenience to municipal employers. In fact, VKA was against the collapse of the employers' coalition:

*"(I)n these years we said it is a big mistake for TdL to get out of the Tariftgemeinschaft ... (in this context) being together with the Bund was also a way to keep the Tariftgemeinschaft alive and hope the TdL would come back at some point" (Interview with official in the top echelon of VKA 2018)*

Second, since VKA hoped to avoid the disintegration of the bargaining coalition and publicly urged the TdL to re-enter, an exit move from the VKA would have

been, on the one hand, incoherent and on the other it would have eliminated any hope to re-establish the joint bargaining coalition in the next future:

*“We asked everytime to TdL to come back. To say so means on the other hand not to go the same way (i.e. imitating TdL’s opt-out)” (Interview with official in the top echelon of VKA 2018)*

Third, what really mattered for VKA at that moment was that the collective bargaining structure be reformed so as to take into consideration the possibility for public municipal employers to apply downward pressures on wages thanks to the private provision of local services. Unless the old collective bargaining structure was reformed, the VKA would have suffered from an internal haemorrhage of its members. In fact, the possibility to privatise and outsource public services *de facto* gave municipal employers the possibility – and the incentive - to circumvent the costly collective contracts of the public sector. Outside the scope of these contracts, the same previously public services could have now been provided privately with cheaper labour costs for the employers. This put pressure on VKA:

*“had VKA not obtained a favourable renegotiation of the terms of the BAT contract, it would have lost many of its members who would have instead opted-out of VKA in order to circumvent the public sector contract and bring down labour costs.”*

As explained by a key VKA’s policy maker taking part in these reform processes:

*“the VKA was very important for the TVöD. We came from the TV-V and we wanted this Tarifvertrag because the BAT was a big problem for our members and we wanted to modernise, deregulate and flexibilise the Tarifvertrag. When we took the decision to negotiate the TVöD, the three employers said it would have to be cost-neutral. (in the process) we wanted to have the TVöD so we did not attack the working hours” (Interview with official in the top echelon of VKA 2018)*

Essentially, the reason why it was convenient for the municipal employers to remain together with the Bund was that, eventually, most of VKA’s wishes were satisfied with the creation of the TVöD contract in 2005 (most notably the introduction of a lower pay grade at the bottom of the new pay scale). Wage restraint was achieved through multi-year moderate lump sums negotiated with the unions ahead of the signature of the new contract. It was, in other words, the federal level which made a step toward complying with the municipalities’ needs in order to preserve the collective bargaining framework in the German public sector, although without the States.

The private sector has had a great influence on the politics of public sector wage restraint. However, the private sector that mattered was not the exporting industrial sector. It was that composed of the sheltered private services, most prominently at the municipal level. Dynamics of privatisations and outsourcing of local public services created an exit option for municipal employers who started to apply pressures on the unions to contain labour costs. This triggered the need for a transformation of the old wage bargaining system. In fact, had the old wage bargaining system not been reformed, municipal employers would have left – as they were leaving – the VKA. This

would have left Ver.di without a reliable and structured negotiating partner at the level of the German municipalities.

As a matter of fact, the unions accepted and contributed to shape the process of institutional change of the collective bargaining framework in the public sector. Faced with the trade-off between a more employer-friendly collective bargaining system versus the collapse of the whole system, the unions strategically opted for the former. Keeping the municipal and federal employers together was surely a second-best. Still, within that constellation, it was the better option for the unions. The latter option would have made them worse off. Needless to say, for the unions this was a concessionary bargain against a full-fledged offensive by the public employers.

## CHAPTER 8. “DIE ÖFFENTLICHEN KASSEN SIND IMMER LEER“, EVEN IN THE AGE OF PROSPERITY

This last chapter differs from the previous two in that it is not narrowly historical. It is rather analytical. I do deal with the developments of the post-2008 period. But I do so not by looking historically at yearly negotiations as I did in the previous two chapters. Here I reflect analytically on the institutional configuration which has resulted from the reform process described. This double process of institutional change has led to a new low-wage institutional equilibrium in public sector wage setting. Within this equilibrium, I posit, only lowest-common-denominator wage policies set around the poorer employers' financial capacity to pay can now be agreed upon. This creates a “wage restraint bias” in Germany's public sector wage setting which prevents the pursuit of policies of public sector wage inflation. In what follows I explain why and how this occurs by unpacking the micro-foundations of this new institutional configuration.

The evolution of public sector wage setting in post-reunification Germany is a trajectory riddled with economic and political problems. Problems require solutions. Indeed, ever since West and East Germany have been reunified, history has moved fast. The old stability-oriented system has undergone several major changes. Most prominently, the system of public sector collective bargaining has changed from being centralised under the leadership of the federal Minister of the Interior into a two-tiered system in which the Länder employers now negotiate their own terms of employment with the unions. Similarly, in the civil service, the legislative competence on civil servants' career structures and pay has shifted back to the Länder governments. While until 2006 the civil service was uniform around the country, the fact that each Land can now legislate on their civil servants' terms of employment has led to a fragmentation of the system. Civil servants' career regulations and pay systems now vary increasingly across the German States. Richer States' greater ability to pay means greater capacity to recruit. This, in turn, implies winners and losers within a partially competitive system.

Before the turbulent 2000s, wage bargaining ensured that public employees within the three levels of the German public administration would receive equal wage setting treatments. Problems of vertical coordination among the three employers were resolved through wage bargaining centralisation *within* the employers' *Tarifgemeinschaft*. The need to ensure an equal treatment between the public employees (subjected to negotiations with unions) and the civil servants (subjected to legislation) was resolved through a process of state-led coordination ensured by the Ministry of the Interior. There used to be an *intra-public-sector pattern bargaining* with the Ministry of the Interior at its core, acting as the transmission belt. In Germany, the three public

employers led by the Minister of the Interior would generally first negotiate collectively with the unions whose demands were coordinated by the ÖTV. After an agreement could be reached via free and independent negotiations, the collectively agreed provisions would then be transferred to the civil servants via legislation approved by parliament. This ensured that wage setting was coordinated between the two legal spheres of the German public employment: the one subjected to labour contracts and the one subjected to state sovereignty. Within the German civil service across the country, coordination was ensured by the federal nature of centralized legislation which applied uniformly in all the States.

Apart from very rare occasions, collective bargaining always took precedence over state sovereignty as a mode of intra-public-sector wage coordination. Attempts to reverse the pattern have occurred. The historical reconstruction has shown that under circumstances of financial need, there have been attempts by some state actors to deploy sovereign authority in civil servants' wage determination to unilaterally impose restraint and disempower unions in collective bargaining negotiations. The success of these attempts was rather rare, either because public employers were internally divided and political support could not be mobilized (e.g. in 1992) or because they eventually deemed it to be unwise due to their political weakness (e.g. in 1999). As a result, even in Germany, the actual capacity of public employers to behave as sovereigns in public sector wage setting has been shown to be not absolute but contingent.

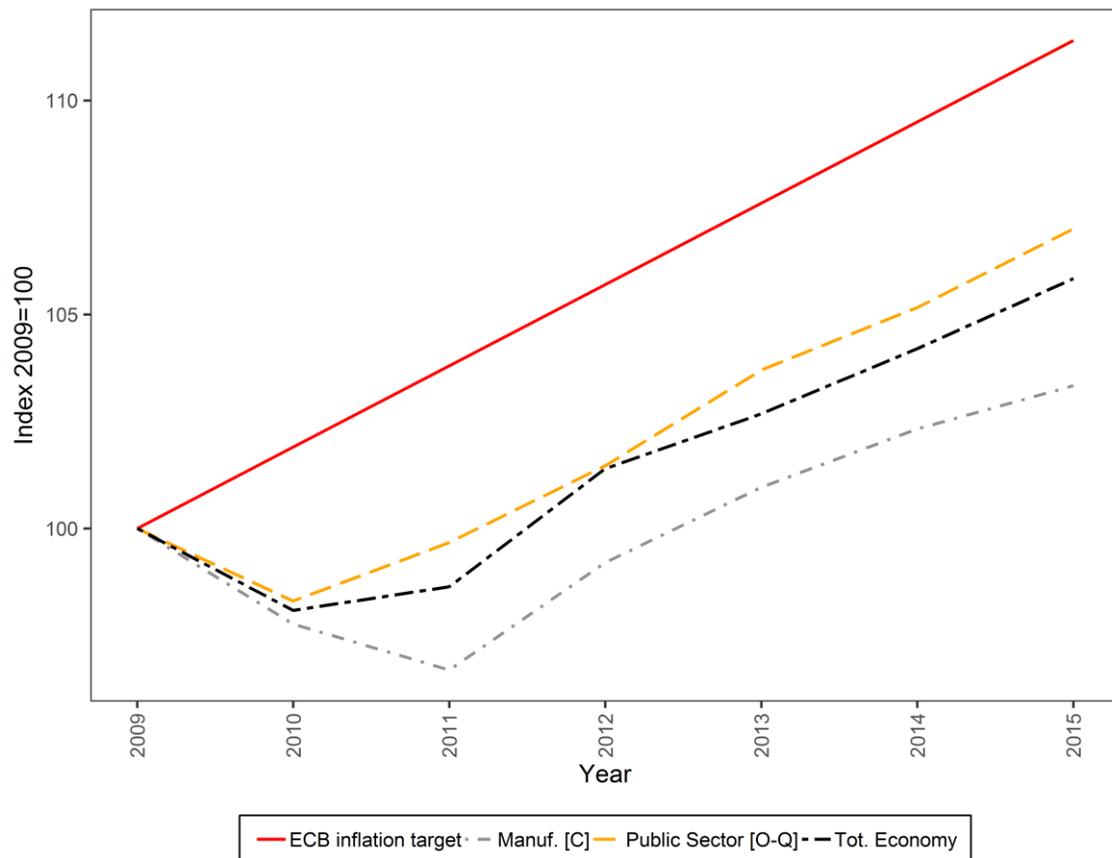
But if the Interior Ministry was the transmission belt, due to its veto capacity, the Finance Ministry was the “referee” behind the scenes. As explained by representative of the German Federal Finance Ministry:

*“the Besoldungsgesetz is drafted by the Interior Ministry. Before the draft is submitted to parliament there would be consultations with all the associations and also the Ministry of Finance would be involved. Before the draft reaches the parliament there is the need for a decision by the whole cabinet and this requires the approval of the Ministry of Finance because the remuneration for civil servants also qualifies as a measure having financial impact ... there are points that need to be discussed between the two ministries (i.e. horizontal coordination) because obviously the Ministry of the Interior feels responsible for ensuring a strong and well-functioning public service, and so do we. But at the same time, the Finance Ministry is responsible for the budget and we always have to keep an eye on public finances and budgetary consolidation” (Interview with a State Secretary in the German Finance Ministry 2017).*

Indeed, the prominent role of the Finance Ministry in public sector wage setting became evident in 1996 when Theo Waigel had to take the lead in steering a process of public sector wage restraint. This was meant to make sure Germany would meet the Maastricht rules on time. Thanks to public sector wage restraint, Germany met the Maastricht criteria and the EMU was launched. Since then, the institutional and constitutional reforms of the 2000s have led to a new wage setting institutional configuration which is fragmented along three legal dimensions: the TVöD contract regulates federal and municipal public employees; the TV-L contract regulates Länder

public employees; each Land's legislation regulates employment conditions of the State's civil servants. As a result of these developments the system of public sector wage determination is now "neither fully centralised nor fully decentralised". This has paved the way to an interesting puzzle which concerns the wage developments of the post-reforms era.

Figure 17: Trajectory of public sector wage setting in the aftermath of the crisis



Source: EU KLEMS. Hourly wages are discounted by hourly labour productivity in total economy.

According to the Calmfors and Driffill (1988) model (see sub-section 3.4 for a review) we should expect wage inflation to emerge in such a system based on intermediate-level wage bargaining. This should become even more apparent in the German public sector considering that Germany is, according to the fiscal federalism literature, characterised by *soft budget constraints* in the vertical fiscal relations between the Länder and the Federation (Manow 2005; Rodden 2006; Rodden, Eskeland, and Litvack 2003). Since the Federal government cannot credibly commit that it will not foot the bill of sub-national governments' overspending, it would be reasonable to expect public sector wage inflation to emerge after the reforms of the 2000s. Such an expectation should also be reinforced by Germany's currently tight labour markets and the very good shape of the public finances after 2007. Germany has lately reported consecutive budget surpluses. Yet figure 17 shows that public sector wages - even in

the age of prosperity and decentralised wage bargaining - are not overshooting. Rather, as argued by Keller (2014), there is a “continuation of early austerity measures” in the German public sector. Although the trajectory of downward fiscal adjustment has been reversed since 2007, public wages have, at best, grown in line with productivity and inflation rates. There seems to be no scope for a policy of public sector wage inflation in Germany, even in times of budget surpluses. Why is that? Why are the German public employers not pursuing a policy of public sector wage inflation in the absence of the need for fiscal consolidation? Or, put it somehow differently, why are sub-national governments not “overgrazing the fiscal commons” in a semi-decentralised system of public sector wage setting?

In what follows, I conclude the historical German case study by suggesting that, what seemed like a fragmented and chaotic reform process has instead now institutionalised a wage bargaining system with its own logic and coherence. The two parallel processes of institutional and constitutional reforms have eventually led to the creation of a new “institutional equilibrium” in the German public sector. By institutional equilibrium I mean a situation in which an institutional change of the current wage bargaining system would make each of the actors involved worse off. All the public employers have now an interest in maintaining the institutionalised *status quo*, even though these interests are diverse within the public employers’ camp. The new “multi-dimensional” system allows the German public employers to strike a balance between the need to contain the fiscal costs of wage determination and the need to remain competitive recruiters vis-à-vis the private sector. For sure, the unions are not in an ideal position. But for them, given the structural shift of the balance of power which has occurred, challenging the *status quo* has become hard. At any rate, even if they were to succeed, given the divisions among the public employers, a change in the *status quo* can only mean the full disintegration of public sector collective bargaining – which is exactly what the unions so eagerly tried to avoid via concessionary bargaining in the reforms of the 2000s. Thus, the unions have now accepted the new institutional constellation, within which they now try to achieve incremental improvements for the public sector labour force.

Thus, to preview my answer to the aforementioned questions, I posit that the reason for the lack of public sector wage inflation during the age of prosperity is to be found in the “micro-foundations” of this new institutional equilibrium. I posit that restraint stems from the specific decision making rules and processes which characterise this new institutional setting. This is the substance of the next section where I go on unpacking the features of this new equilibrium.

### 8.1 A NEW INSTITUTIONAL EQUILIBRIUM IN THE GERMAN PUBLIC SECTOR

#### THE TVÖD CONTRACT

In the TVöD contract three key different collective actors come to interact for the scope of regulating pay settlements for municipal and federal public employees. Two different public employers have to interact with each other and then with the unions. The federal level is represented by the federal Minister of the Interior and the municipal level by the VKA. The unions' front is generally led by Ver.di. The crucial actor to be looking at in order to understand the inner logic of the TVöD contract is the VKA. This is due to the features of the German political system and the asymmetric nature of the German fiscal constitution which the dissertation has identified.

Municipalities bear extensive administrative responsibilities, for which they require a large amount of public personnel. This means a high proportion of personnel costs in their books. At the same time, however, municipalities cannot manipulate their tax revenues at will. They can do so only to a minimum extent. The room for manoeuvring within those few local taxes they have control over is limited by rising competition to attract new businesses. Borrowing is allowed only for investment expenditures and municipalities' debt has already been growing exponentially since reunification and deindustrialization. The sum of debts at the municipal level has skyrocketed from €71,618m (€966 per citizen) in 1991 to €135,178m in 2012 (€1781 per person). This is just about the double. Some of the most financially troubled municipalities can be found in Saarland, Rhineland-Palatinate, North Rhine-Westphalia and Hessen. Since Eastern municipalities benefit from specific programmes of fiscal transfers, the majority of poorer municipalities are located in the West (Keller 2014, 390-91). Moreover, the "political space" within which municipal employers can increase the fees of local public services is limited by their proximity and direct accountability to residents. The conjunction of these peculiar administrative and fiscal structures curtails the municipal employers' ability to pay and creates pressures to cut on the expenditures' side.

Within the TVöD framework for collective bargaining, before negotiating with the unions, the federal and the municipal level have to coordinate *vertically* with each other in order to proceed in wage setting. However, within the public employers' camp *horizontal* coordination is much easier at the federal level than at the municipal level. At the federal level, horizontal coordination among state actors generally (i.e. under conditions of financial stability) means that the Interior Minister has to obtain a green light from the responsible state secretary in the Finance Ministry. At the municipal level the constellation is much more complex. Fundamental decisions on collective bargaining there are taken within the VKA's *Mitgliederversammlung* (members' general assembly). According to the VKA's *Satzung* (statute), the general assembly is composed of the representatives of the 16 States' municipal associations (KAV) who send their members on the basis of a weighted proportion of the employees in their municipal administrations/companies. Decisions on wage policy require a  $\frac{3}{4}$  majority within the assembly. Since financial troubles are widespread across municipalities, only a "compromise at the bottom" is capable of winning the vote of poorer municipalities

necessary to achieve a qualified majority in the general assembly. This consensus-based voting procedure implies that only “lowest common denominator wage policies” have a chance of being approved by the municipal decision-makers.

This means that, as much as market conditions allow, wage policies have to be calibrated according to the financial needs of the poorer municipalities. This is because, since employers’ membership in the employers’ association is voluntary, pay settlements beyond local employers’ ability to pay would trigger an internal haemorrhage within the VKA. Were municipal employers not to find membership advantageous, they would, sooner or later, pull out and set their own local contracts. Indeed, this was a real possibility in the early 2000s and the reform of the BAT system was exactly meant to address this very problem. This new system creates notable advantages also for the richer municipalities. In fact, through lowest common denominator wage policies, those employers with greater ability to pay – who would have to pay higher settlements otherwise – seal cheaper pay settlements and enjoy fiscal savings. This means that they reduce their *fiscal opportunity costs*, i.e. the saved fiscal resources can be diverted to other public functions (i.e. hoarding, reducing current fees, public investment and other expenditures).

Thus, within this constellation, no negotiating actor has an interest in the disintegration of the system. From the unions’ perspective, what needs to be avoided is the collapse of horizontal coordination among the municipalities which would mean fragmented wage bargaining across Germany’s thousands of municipalities. The employers’ organisations VKA and KVA clearly do not wish to lose their members. The municipal employers themselves benefit from delegating wage setting tasks to the employers’ organisations because this lowers negotiation’s transactions costs and eliminates the need for them to set up costly internal administrations for handling wage bargaining. However, these benefits remain valuable only to the extent in which the collective bargaining framework ensures pay settlements which remain within the limits of municipal employers’ ability to pay. Since the Ministry of the Interior is aware of the complexity of accommodating different stakeholders within the VKA, under normal circumstances, vertical coordination between the ministry and the VKA occurs “by default”, with the federal level accommodating the needs of the municipal level. When faced with a trade-off between a lowest common denominator pay settlement and the paralysis of the wage bargaining machinery, the Federation has a clear preference for building a common ground with the municipal employers. After all, the federal level features only a tiny minority of public employees among which most of these are civil servant not subjected to collective bargaining regulation.

To put it with the words with a VKA official involved in the reform process:

*“we (the VKA) try to find a common way to get an agreement. For the municipal level it is important to keep wages down because of tax reasons ... at the federal level it is only one, sometimes two people who have to decide, the interior and/or the Finance Ministers. On the other side there are many people who have to decide and there are many different interests*

*that need to be balanced ... the interests of the municipalities and that of the Ministry of the Interior are not always the same. But the Federation has the interest that the municipalities can live with their budgets. Ministries also don't want that the public sector gets too high wages that can be the guideline for other sectors ... the line of interest is different between the Bund and the VKA. In the VKA there are many stakeholders in the Mitgliederversammlung and we need more time to get to a common opinion than one person. It is an organisational dynamic. The Federation knows that it cannot push for a stance around which an agreement cannot be reached among the many stakeholders of the VKA" (Interview with official in the top echelon of VKA 2018)*

This process of consensus-based decision making, I posit, prevents the very possibility to pursue inflationary pay settlements within the scope of the TVöD contract. The unions are caught in a dilemma, i.e. whether to challenge this equilibrium in the search for higher pay settlements or accept the *status quo* characterised by moderate wage increases. The crucial reason for the unions not to challenge the *status quo* is that, if they were to challenge it, they would most likely lose the VKA as a negotiating partner. As a result, their very negotiating capacity at the municipal level would be severely hampered. Furthermore, if the unions challenged the *status quo*, the municipal employers could always exercise their “exit option” and privatise or outsource public services to private entities beyond the TVöD remits. This would reduce unions’ strength and reach even further.

Funnily enough – from the old pattern bargaining perspective – it is instead competition with the private sector that contributes to ensure public wages do not lag excessively behind the private sector. Thus inter-sectoral dynamics in Germany play the opposite role than the one ascribed to them by the literature (sub-section 3.5). Wage developments in the private services constitute rather a floor which prevents the public employers to squeeze their workers even further. Municipal employers need public wages to remain attractive enough to be successful in the current *Talent Krieg* (war for talents) which is ongoing vis-à-vis private employers.

#### *THE TV-L CONTRACT AND THE LÄNDER'S BEAMTENBESOLDUNGSGESETZ: TWO SIDES OF THE SAME COIN*

In the TV-L contract two different collective actors come to interact for the scope of regulating pay settlements for the Länder's public employees. The States' employers, represented by TdL, negotiate collectively with the unions. Here, a similar coordination problem occurs, although within a quite different constellation. Similar to the municipal level, the German States bear extensive administrative responsibilities. This implies a high proportion of personnel costs in their books. Similar to the municipalities, the Länder cannot independently manipulate their tax revenues. Revenues are shared across levels according to *ex ante* fixed formulas. Collectively, the Länder could manipulate federal tax legislation via their joint action in Bundesrat. The fact that this would require hard-to-achieve majorities in the two chambers, however, *de facto* implies that

each Land, alone, cannot manipulate its revenues at will. The conjunction of the peculiar German administrative and fiscal structures curtails the Länder employers' ability to pay and creates pressures to cut on the expenditures' side.

In the TV-L contract, States' employers no longer have to coordinate vertically with federal and municipal employers. This was in fact the crucial reason to pull out of the joint bargaining association in the first place and establish the TV-L. Yet the States still need to coordinate with each other horizontally within the employers' association. The effect of Germany's reunification has been that of augmenting the heterogeneity of the German Länder and increasing the spread between the rich and the poor Länder employers. In the TdL, each Land is generally represented by its Finance Minister within the TdL's wage bargaining commission (*Tarifkommission*). Berlin was outside the TdL until it re-joined in 2012. Hessen has never re-joined since it pulled out in 2003. Decisions on wage policy within the TdL wage bargaining commission require a qualified majority of at least 9 out of 15 members. Each state has one vote and this means in theory that smaller/poorer States can outvote richer/bigger States. In practice, however:

*“TdL tries to secure a bigger majority so that the result is a consensus-oriented decision making process” (Interview with official in the top echelon of TdL 2017).*

The reasons for a consensus-oriented approach within the TdL are easily understood. Since membership in the TdL is voluntary, the Länder governments must find membership advantageous. Were them to find it disadvantageous, they would sooner or later leave the association and set up their own bargaining units, just like Hessen and Berlin did. But Berlin recently decided to re-join the TdL, indicating that there must be benefits for both the poor and rich States in remaining within coordinated bargaining. In fact, richer and bigger States like Bavaria could in theory pull out and easily offer higher pay settlements to their public employees to outcompete poorer States. How do poor and rich Länder benefit from state-level coordinated wage bargaining via the TdL?

To begin with, the TV-L contract is already structurally more favourable to the Länder employers than the previous BAT system because:

*“there is a much lower risk of strikes without the municipal level. TV-L has strengthened the negotiating power of TdL” (Interview with official in the top echelon of TdL 2017).*

For the poorer States, the crucial reason to maintain horizontal wage coordination is to avoid a full-fledged competitive system in which they would be net losers. In fact, were each Land to negotiate independently of others, richer public employers (with a greater ability to pay) would be able to offer better terms which would be difficult to replicate for poorer employers. Thus the greatest benefit of coordination for the poorer States is that coordinated bargaining takes out competition for the public employees in a two-tier labour market where, after 2006, Länder can now compete for the civil servants. Yet similar to poor municipalities, the benefits from coordinated bargaining only exist to the extent in which the TV-L contract is set on the basis of poorer States' ability to pay.

In fact, were TV-L to become too expensive for the poor States, they would sooner or later have to pull out and go on their own. All actors in the TdL are obviously aware of the fact that coordinated bargaining can survive only if – and to the extent in which – it accommodates the poorer States’ financial needs.

For the richer States horizontal coordination with the poorer ones pushes wage settlements downward and frees up fiscal resources which they would otherwise have to pay. Were public employees’ wages to be set in a fully competitive system, the richer States would end up paying higher settlements than those agreed collectively – just like in the civil service since 2006. Thus, by being together with poorer States, richer States save money through “lowest common denominator pay settlements” which are calibrated according to poorer States’ ability to pay. This lowers their fiscal opportunity costs and allows governments to divert the resources saved to alternative fiscal uses (e.g. hoarding, reducing fees, expanding services or public investment and other expenditures). Secondly, for richer States coordinated bargaining also creates the opportunity to legitimise moderate pay settlements by shifting the blame on the needs of poorer States’ Finance Ministers.

The richer States have, so to speak, *an interest in being outvoted* in wage policy decisions within the TdL. By compromising on a lowest common denominator agreement, the richer States hide behind the poor ones and enjoy the benefits of moderate settlements. But taking out competition also means rigidity in the capacity to offer better employment terms in order to attract a skilled workforce in the public sector. While this is exactly what the poorer Länder wish for, the rigidity creates recruitment problems for the richer Länder who face harsher competition with the private sector in tighter local labour markets. As TdL officials explain:

*“all States agree that uniformity of employment conditions would be better for all, however there should be some flexibility” (Interview with official in the top echelon of TdL 2017).*

It is here, I maintain, that the parallel decentralisation of the legislative competence for civil servants’ pay and careers comes into play. It ensures flexibility and a new coherence to the system. Not by chance, it was the richer States that pushed within the federalism commission to obtain the *Beamtenbesoldung Kompetenz*. Thus, I argue, the institutional (of the TV-L) and constitutional (of the *Beamtenbesoldungsgesetz*) reforms shall be understood as complementary to each other. What the decentralisation of this legislative competence *de facto* does is to allow a “flexibility valve” to the richer States. While upward competition is prevented in wage contracts by horizontal coordination, richer States’ recruitment needs are met via competition in the civil service. In fact, public employers maintain the discretionary capacity to decide the legal employment status of the newly-hired. Richer States can thus out-compete poorer States by opting for paying better terms in the civil service where they can now unilaterally decree the career and pay provisions.

Table 3: The three dimensions of the new wage setting institutional equilibrium and their key characteristics

	<i>TVöD contract</i>	<i>TV-L contract</i>	<i>Länder's Beamtenbesoldungsgesetz</i>
<i>Type of public sector wage coordination/diversification</i>	Vertical wage coordination between federal and municipal level and horizontal wage coordination across municipalities (through VKA)	Horizontal wage coordination across Länder (through TdL)	Horizontal diversification across Länder
<i>Logic of wage determination</i>	Wage policy set as lowest common denominator that avoids poor municipalities' exit from VKA	Wage policy set as lowest common denominator that avoids poor Länder's exit from TdL	Wage policy set independently by each Land
<i>Type of decision making</i>	Consensus-based joint decision making in coordination forum	Consensus-based joint decision making in coordination forum	Land's specific legislative competence
<i>Type of wage setting outcome</i>	Vertical homogeneity between Federation and municipalities and horizontal homogeneity across municipalities	Horizontal homogeneity for public employees across the Länder	Horizontal heterogeneity for civil servants across the Länder
<i>Direction trend of wage setting</i>	Downwards pressures	Downward pressures	Selective upward pressures (only for rich public employers)
<i>Main public employers' derived benefits from institutional equilibrium</i>	<p>Poorer Municipalities:</p> <ul style="list-style-type: none"> <li>- Avoidance of competitive fiscal federalism dynamics in public sector wage setting</li> </ul> <p>Richer Municipalities:</p> <ul style="list-style-type: none"> <li>- Minimisation of wage setting's fiscal burden</li> </ul> <p>Both:</p> <ul style="list-style-type: none"> <li>- Outsourcing of labour conflict</li> <li>- Minimisation of collective bargaining's transaction costs</li> </ul> <p>Federal level:</p> <ul style="list-style-type: none"> <li>- Maintenance of collective bargaining structure</li> </ul>	<p>Poorer Länder:</p> <ul style="list-style-type: none"> <li>- Avoidance of competitive fiscal federalism dynamics in public sector wage setting</li> </ul> <p>Richer Länder:</p> <ul style="list-style-type: none"> <li>- Minimisation of wage setting's fiscal burden</li> </ul> <p>Both:</p> <ul style="list-style-type: none"> <li>- Outsourcing of labour conflict</li> <li>- Minimisation of collective bargaining's transaction costs</li> </ul>	<p>Richer Länder:</p> <ul style="list-style-type: none"> <li>- Upward wage flexibility through <i>in melius</i> wage deviations to compete with local private employers</li> </ul>
<i>Unions' derived benefits from institutional equilibrium</i>	Maintenance of collective bargaining structure; orderly and manageable process of collective bargaining (preferred to atomistic bargaining); maximisation of uniformity of pay and employment conditions	Maintenance of collective bargaining structure; orderly and manageable process of collective bargaining (preferred to atomistic bargaining); maximisation of uniformity of pay and employment conditions	Political ties with local authorities in the representation of civil servants' interests

In so doing, the richer and poorer Länder employers can strike the necessary balance between two opposite interests: wage moderation and avoidance of fully competitive labour market (of interest to poor States) and recruitment flexibility (of interest to rich States). Through wage bargaining calibrated on the poorer States' financial needs, both the poorer and richer States achieve moderate settlements which keep the financial costs of public sector wage setting under control. Opting for the “civil service way”

then constitutes *de facto* an opening clause *in melius* which enables the richer States to remain attractive vis-à-vis private employers. Also in the TV-L, competition with the private sector helps to set a limit to the extent in which public employers can enforce restraint.

None of the collective actors involved has an interest in challenging the status quo. TdL has an organisational interest in preventing the exit of its members and the collapse of the organisation. As such, it has – and did have – the willingness and the capacity to accommodate the conflicts of interest between the poor and rich States. At this point, it does not really matter who the poor and rich States are and if their composition changes over time. What structures these coordination dynamics is the presence of two types of qualitatively different public employers with opposite financial and recruitment needs embedded within a rigid fiscal federalism system where they lack fiscal autonomy. The poor States benefit from the fact that TdL institutionalises a levelling field in wage bargaining which is set on the basis of their financial needs. The rich States benefit from all sides. On the one hand they extract savings from the low-wage equilibrium in collective bargaining. On the other, they can opt-out and resort to the civil service if and when they deem it appropriate. All the bargaining parts have furthermore an interest in coordinated bargaining via the TdL in that it takes out the labour conflict away from the local administrative units. Furthermore, TdL provides legal services and platform for best practices where Finance Ministers come to exchange views and expertise.

TdL also lowers substantially wage setting's transaction costs. Were a state to pull out of the TdL, it would need to set up a costly administrative machinery to engage in state level negotiations with the unions. In fact, Hessen, which opted to pull out, now:

*“needs a lot of resources to negotiate and at the end of the day the agreement Hessen reaches is mostly similar to TdL's. Hessen ended up in a situation in which they get the TdL's contract without influencing it” (Interview with official in the top echelon of TdL 2017)*

Thus, all negotiating actors have an interest in compromising around lowest common denominator bargains to avoid a blockage in public sector wage setting and the paralysis of the administrative machinery. For the unions challenging the system is very difficult. First of all, their mobilisation capacity is much weaker at the States' level and the unions themselves struggle to mobilise public sector workers, most notably in the education sector. Secondly, were the unions to challenge this equilibrium, what they would most likely obtain is the disintegration of horizontal coordination across States. This will lead to a competitive federalism system and an ever fragmented landscape. Employment and pay conditions across States would become even more heterogeneous. In wage bargaining unions would have to conduct simultaneously different negotiations and eventually industrial actions in the different 16 States. This would undermine the unions' capacity to defend “the German public workforce”.

## CONCLUSIONS

The central question which this dissertation has addressed is the following. *What explains Germany's trajectory of public sector wage restraint vis-à-vis its EMU peers?* The necessity to pose this question emerged out of empirical and theoretical considerations. Beginning with the latter, given the failure of the main alternative scholarly explanation in providing a satisfying answer to the question, the dissertation has proceeded by asking the following theoretical question. *If we cannot explain Germany's public sector wage restraint through the theory of inter-sectoral wage coordination via export-led pattern bargaining, what other factors, so far unaccounted for, explain Germany's trajectory of public sector wage restraint?* The answer to these questions speaks to the wider necessity for policy makers in Europe to understand the causes behind the divergent pattern of public sectors' wage growth which can be observed since the launch of the EMU in 1999. As such, these questions constitute a subset of the more general question: *why have countries which were subjected to the same hard monetary regime experienced such divergent trajectories of wage growth in their public sectors?* Here are the answers this dissertation provides.

What explains Germany's trajectory of public sector wage restraint vis-à-vis its EMU peers? The short answer to this question is as follows. The proximate cause is to be attributed to the political choices which the German public employers have made in order to pursue a more general policy of fiscal consolidation. These choices were shaped by the state's institutional setting within which they were taken. Thus, the remote causes of these choices are to be found in the interactive effect of three institutional domains. The German fiscal federalism system constraints the public employers' capacity to manipulate their fiscal revenues at will. This curtails the employers' fiscal space and triggers the need to act on the expenditures' side. The politico-administrative system, however, is structured in a way that sub-national governments bear the bulk of the personnel costs. Thus employers within the German public administration are not equal. They are confronted with asymmetric stocks of labours costs. This, in turn, creates scope for conflicts of interests among the public employers. These conflicts of interests were crucial in the collapse of the public employers' collective bargaining coalition in 2003 and the transferral of the legislative competence on civil servants' careers and pay back to the Länder in 2006. As a result of this rift, a political misalignment emerged among the public employers. In the policy networks which characterise Germany's capitalism (Katzenstein 1987), they still *rule together* but, as far as public sector wage setting is concerned, they *stand divided*.

Given the legal system of employment relations in the public sector, wage restraint was aggressively pursued by the public employers through collective bargaining – for the public employees – and via unilateral legislation – for the civil servants. In collective

bargaining the employers pushed the unions against the wall and extracted fiscal savings from wage restraint, extended working hours, reduced holidays and bonuses and cut in other qualitative aspects of the employment relation. Through unilateral determination, the public employers could only enforce restraint unilaterally in 1994. They tried in other occasions too but they failed to overcome internal problems of coordination: they were either politically divided or politically weak.

If we cannot explain Germany's public sector wage restraint through the theory of inter-sectoral wage coordination via export-led pattern bargaining, what other factors, so far unaccounted for, explain Germany's trajectory of public sector wage restraint? The short answer to this question is as follows: the state, its institutional configuration, the role of the public employers producing policy within the state's institutional configuration and, perhaps most importantly, the intrinsically fiscal and therefore political nature of public sector wage setting.

Why have countries which were subjected to the same hard monetary regime experienced such divergent trajectories of wage growth in their public sectors? Regrettably, this dissertation does not provide a satisfying answer to this wider question. Answering this question thoroughly was beyond its narrower scope. What I can do, however, is to suggest a likely avenue from where to start looking for answers. The dissertation carries with it some important insights which have implications beyond the case study pursued here.

First, the state matters. It is not neutral and does much more than serving the interests of dominant export sector's elites. The state has its own interests, preferences and strategies which may but *must not necessarily* be aligned to those of the export sector. The state is no subaltern to the export sector and is instead the central entity from which to approach the study of public sector wage setting.

Second, the state is not a unitary entity. It is an institutional contextualisation within which various state actors – each of them with their own organisational interests, preferences and strategies – interact to produce policy. The fragmented and decentralised nature of today's states creates scope for intra-state conflicts of interest. State actors may be divided along different dimensions. They may be divided vertically across different levels of government. Or they may be divided horizontally across different state institutions (ministries, agencies, etc.). Furthermore, they may be divided politically within the same coalition in government. To produce policy, state actors have to overcome collective action problems and in the face of their internal dividedness they must mobilise the political support and action resources necessary to transform their preferences into action.

When studying policy making these are more than just nuances. These are rather crucial aspects behind policy choices. This is particularly true for public sector wage setting considering that it necessarily requires the coordination of those state actors in charge of the fiscal and wage policy instruments. The political authority within these

policy areas is likely to be shared among different actors within the polity's sub-national centres of power. Thus, when the industrial relations literature speaks of "the state in industrial relations" what it shall rather mean, I suggest, is the study of state actors involved in the process of public sector's wage determination within the state's institutional configuration.

Third, continuing to study public sector wage policy as a mere phenomenon of inter-sectoral wage coordination and export sector dominance ignores the fundamental fact that public sector wage policy is fiscal policy. As such, the starting point to understand public sector wage policy is to look at the political interactions which produce – and the political coalitions which underpin – fiscal policy. Finding the answer to the big puzzle of public sector wage divergence in Europe is likely to be facilitated by taking into account the insights of this dissertation in future research.

*PUBLIC EMPLOYERS AS SEMISOVEREIGN STATE ACTORS AND THE POLITICAL ECONOMY OF PUBLIC SECTOR WAGE RESTRAINT IN GERMANY*

This section provides a summary of the historical sequence of events through which public sector wage restraint came about in Germany. Before proceeding, a caveat is of order. Even though the question posed in the dissertation refers to the EMU period, I have deemed appropriate to begin the analysis of the German case from the country's reunification. Through the causal process observation, I have found that the historical causal sequences of the 1990s and the 2000s are substantially different in terms of the politics which produced public sector wage restraint. What makes them different is the *political misalignment* which emerged within the public employers' camp in the early 2000s. This was "state-structured" in the sense that the public employers' conflict of interests behind the emergence of this cleavage is rooted in the very unique structure of the German state's institutional setting. The rift between the Länder, on the one hand, and the federal and municipal employers on the other, put an end to the historical public employers' collective bargaining coalition and paved the way to the decentralisation of public sector wage bargaining to the the Länder level.

The *Tarifgemeinschaft* had hitherto ensured, for more than forty years, centralised and encompassing wage setting in the German public sector. This, in turn, guaranteed uniformity of employment conditions and pay terms vertically across the three levels of the German public administration and horizontally across the many municipalities and Länder of Germany. A similar development occurred with regard to civil servants' pay determination, which in Germany is a distinct legal sphere. At about the same time, the (richer) Länder pushed for and obtained via the reform of the fiscal federalism system in 2006 the return of the legislative competence on civil servants' careers and pay. The decentralisation of the *Beamtenbesoldung Kompetenz* has undermined the uniformity of the civil service across the country and has injected a component of *competitive federalism* within Germany's overall cooperative federalism.

As a result, the two dynamics of restraint are qualitatively different. In the 1990s restraint was pursued within the context of centralised collective bargaining by public employers which were internally aligned and coalesced behind the leadership of the federal Ministry of Finance. In the 2000s, restraint was pursued after the collapse of the public employers' political coalition and the disintegration of centralised bargaining. Public employers grew internally divided and eventually decided to take different paths. The emergence of a political misalignment affected both the process and the outcomes of the reforms. This reform process has eventually resulted in the institutionalisation of what I call a *low-wage institutional equilibrium* in Germany's public sector wage setting. The two sequences are thus different in their specificities because, while the restraint of 1997 occurred under the pressure of an external constraint (the Maastricht's *vincolo esterno*), the restraint of the 2000s occurred in concomitance with and in relation to a double process of institutional and constitutional change of the whole legal framework for public sector wage determination.

These differences are central to a detailed historical explanation of the German case. To appreciate them fully, it is worth treating the two causal chains separately as I did in the empirical chapters. The abstract fiscal mechanism which instead explains restraint in these two sequences will then be discussed subsequently. In what follows I recapitulate the two sequences of events which led to public sector wage setting in the 1990s and the 2000s, respectively.

#### *THE 1990S. DIE BLÜHENDEN LANDSCHAFTEN HIT THE VINCOLO ESTERNO*

German reunification in 1990 constituted an extraordinary fiscal event in Germany's economic history. All of a sudden, German policy makers were confronted with the herculean task of integrating a command economy into West-Germany's capitalist system. The shock-therapy approach which was adopted to guide the transition led to the collapse of the structurally-weak Eastern Germany's economic system. The economic hardship of the East, in turn, required a more expansionary fiscal policy to compensate the losers of this capitalist transition and support the economic sector. On the day of currency unification, the CDU Chancellor Helmut Kohl had promised to turn the new Länder into blossoming landscapes (*Blühenden Landschaften*). To win the elections, however, the Chancellor had also promised not to raise taxes and make the citizens pay for the reunification effort. The government tolerated budget deficits until 1993 when it was forced to make a U-turn in fiscal policy by the hard monetary stance taken by the Bundesbank. The bulk of the reunification bill was footed by the federal budget. The government's loss of fiscal discipline was financed through a combination of deficits and increased social security levies. The increase of taxes was avoided by shifting the fiscal costs of reunification to the budgets of the social insurance schemes, a recurrent adjustment practice in the German political economy (Manow and Seils 2000).

Next to the fiscal expansion needed to subsidise the East, the trade unions' loss of wage discipline contributed further to inflate economy. Militant unions extracted substantial wage increases across the whole economy in the years 1990, 1991 and 1992. During the latter year, after one of the most disruptive public sector strike in the history of Germany, ÖTV extracted a 5.4% wage increase. This was the last time something similar would happen.

To remedy the loss of fiscal and wage discipline and curb inflationary pressures, in summer 1992 the Bundesbank tightened monetary policy to levels hitherto unimaginable. The bank intended to hamper the government's expansionary fiscal stance and punish the government in its function of public employer vis-à-vis the trade unions, against whom it had caved in granting generous wage increases. It also aimed curb the trade unions' "inconsiderate" demands. This marked the end of the short-lived interval of expansionary fiscal and wage policy in Germany. The Bundesbank, in the exercise of its legal mandate, imposed a stop-go monetary policy on the German economy which caused an economic depression whose effects would be felt for a decade (Jörg Bibow 2003). An export-led recovery was exactly what these policy makers were hoping for. In the event, however, economic growth slowed down and unemployment soared. As a result, tax revenues decreased and social expenditures increased, reducing the public employers' fiscal space. The Bundesbank's non-accommodating monetary stance, a hard *vincolo interno* (internal constraint) for the government, affected the course of fiscal and hence of public sector wage policy in the years ahead.

With a tighter fiscal space, the public employers moved on the offensive. Already in 1992 the FDP economics minister Jürgen Möllemann had tried to impose a statutory pay limit on civil servants' pay with the hope to send a strong signal of moderation throughout the economy. Sovereign authority could not be deployed, however, because the public employers were divided on the issue. The CDU Interior Minister Rudolf Seiters in charge of civil servants' legislation opposed unilateral intervention and the proposal faded away. With the worsening of the financial situation, the trajectory of public sector wage restraint was inaugurated in 1994 when the government did legislate on a zero wage round for those civil servants in higher pay grades.

Public sector wage restraint was pursued forcefully in 1996. This was ahead of the fiscal year 1997 on the basis of which the first evaluations for EMU entry would have occurred. During the previous years, the Finance Minister Theo Waigel had styled himself as the stubborn defender of financial stability in the soon-to-be monetary union, requesting the introduction of the stability pact. By autumn 1995, however, the German economy slowed down and a shortfall of tax revenues in conjunction with higher social expenditures led to an unexpectedly high budget deficit. When it became clear – in winter 1996 – that Germany could fail to meet the 3% deficit criterion of the Maastricht treaty, the public employers hardened their stance. EMU accession was indeed a hard *vincolo esterno*. Had Germany failed to comply with the rules itself wanted in the first

place, EMU's launch would have probably be delayed or, possibly, even abandoned. In spring 1996, a savings package was approved by the Christian-liberal coalition. The package intended to rectify the budget deficit by DM50bn through substantial savings to be achieved via a wage freeze in the public sector (DM23bn). Due to the legal system of public sector industrial relations, the public employers had to negotiate the restraint with the unions within the framework of independent collective bargaining. During negotiations, to achieve fiscal savings, the public employers pushed also for longer working hours, cuts in sickness pay in overtime pay and cuts in holiday provisions. Eventually, the unions were pushed against the wall by the public employers which were determined to extract the fiscal savings necessary to bring down the deficit below the 3% level. The parts compromised on a moderate settlement which included a DM300 lump sum for 1996 and a 1.3% pay rate for 1997. This concessionary bargain enabled the unions to avoid the spectre of a pay freeze. Most importantly to them, unions avoided cuts in sickness and overtime pay. Eventually, German public employers extracted substantial savings from a very moderate wage bargain and managed to bring the deficit right below the 3%. The SPD in opposition and the Länder were blocking through the Bundesrat other savings-extracting measures proposed by the government. Due to this opposition, had the public employers not pursued restraint via the public sector wage setting arena (to circumvent the veto in the Bundesrat), Germany would have most likely missed the Maastricht target.

In the production of public sector wage restraint in the 1990s, the federal government was the *protagonist* under the firm leadership of the Finance Minister Theo Waigel. The public employers went on the offensive to reduce the fiscal burden of wage setting in the face of a tighter fiscal space available. In the event, the trade unions were *antagonists* to this employers' offensive. With regard to export sector's wage setters, as described in detail in the empirical chapter, I could find no evidence of attempts being made to impose a pattern of moderation upon the public sector. It is thus better to consider them *consenters* vis-à-vis the government's strategy of fiscal consolidation and public sector wage restraint. This is understandable. After all, fiscal restraint is likely to lower the future tax burden, contributes to deflate the economy and sends a moderation signal to the private sector's wage negotiations. So, public sector wage cum fiscal restraint works out as a perfect complementarity for the export-led growth model. Export sector's actors, however, were certainly not the protagonists behind the production of public sector wage restraint. Nor was restraint imposed via export-led inter-sectoral wage coordination. To the contrary, I have found historical instances where it was the unions in the export sector who managed to extract higher pay settlements which then enabled public sector unions to push up the public employers' initially moderate offers. Independently of the export sector, the German public employers were determined to curtail the personnel costs of their administrations for reasons purely related to public finance and not export competitiveness.

*THE 2000s. THE DOUBLE LÄNDER OFFENSIVE: INSTITUTIONAL AND CONSTITUTIONAL REFORMS OF PUBLIC SECTOR WAGE SETTING*

In 1998 a Red-Green coalition took power which, under the leadership of Gerhard Schröder, took a supply-side “new centre” approach to economic policy making. Central to this strategy was the phasing in of a business-friendly tax reform which created a hole in the finances of the public employers. Particularly affected were the Länder employers who, after the entry into force of the reform’s 2001 step, experienced a severe deterioration of their deficits. Given the high unemployment level at the time, lower revenues came to coincide with high social expenditures. All of these factors aggravated further the ongoing fiscal crisis of the German state and urged the public employers to take an increasingly assertive stance in public sector wage setting.

The combination of lower revenues induced by the tax reform and the settlement of an expensive public sector contract in the 2002 bargaining season created an explosive mix. Sub-national governments had already become vocal about public sector settlements beyond their ability to pay after 1999. The agreement reached under the leadership of the federal level in January 2003 was the straw that broke the camel’s back. The Länder deemed it too expensive and threatened to leave the TdL, were the TdL not to pull out of the historical employers’ coalition. The city-state of Berlin did in fact pull out in order to engage in negotiations for cheaper terms with the unions. At the same time, the 2002 contract envisaged the beginning of a concerted reform process aimed at reforming and modernizing the old legal framework for collective bargaining in the public sector. After first attempts, the joint negotiations between the employers and the unions broke down due to the Länder offensive on working hours. Given that many of the Länder employers had already extended weekly working hours for their civil servants through legislation, they were now demanding similar provisions be applied to the public employees in spite of the terms agreed in the previous collective agreement.

The controversy escalated. TdL unilaterally quit the regulations on working hours and the unions stopped the ongoing negotiations of the collective bargaining framework. Eventually, TdL decided to quit the negotiations altogether and talks resumed between the unions and federal and municipal employers. Negotiations successfully led to the adoption of the new TVöD contract in February 2005. The agreement reformed the system and eliminated the old distinction between white- and blue-collar workers in the public sector. The TVöD incorporated the needs of the municipal employers to arrive at a more modern and flexible framework which would have eliminated the incentive for them to privatise and outsource public services to shrink labour costs. Wage restraint occurred in the form of meagre lump-sums (and other qualitative types of downgrading) accepted by the unions which covered the years 2005-2007.

After agreeing on the TVöD, the unions tried in vain to convince the Länder to re-join the collective bargaining coalition or enter into similar provisions. The Länder,

however, were determined to continue their offensive on working hours which they needed to reduce costs. Throughout 2005 and the spring of 2006, Ver.di fought on different fronts against municipal and Länder employers to prevent the extension of the working hours. The environment became increasingly combative during 2006 and a compromise with TdL could only be reached in late May, after 16 consecutive weeks of strikes. This institutionalised the new TV-L contract. In the reform of the collective bargaining framework, wage restraint was pursued through a wage freeze in 2006 and the agreement of moderate lump-sums to be disbursed in 2007. In parallel, the Länder engaged in a process of constitutional reforms. Through the federalism commission, under the leadership of richer states, the Länder were claiming back the legislative competence on civil servants' careers and pay. After a first failed attempt at reforming the constitution in late 2004, the reform process was made possible within the new political constellation which emerged with the grand-coalition which took power in 2005. In 2006 the legal competence was returned to the Länder, completing the three-dimensional overhaul of the system of public sector wage determination.

In these processes, the key protagonists behind the production of wage restraint were the Länder employers and, as far as the creation of the TVöD is concerned, the municipal employers. Export sector wage setters cannot be regarded as key policy actors neither with regard to the process of wage restraint nor with regard to the process of institutional and constitutional change.

*THE FISCAL MECHANISM OF PUBLIC SECTOR WAGE RESTRAINT: WIDER IMPLICATIONS FOR CPE THEORY AND POLICY MAKING IN THE EMU*

If we cannot explain Germany's public sector wage restraint through the theory of inter-sectoral wage coordination via export-led pattern bargaining, what other factors, so far unaccounted for, explain Germany's trajectory of public sector wage restraint? Through theory-guided process tracing I have uncovered, inductively, what I term "the fiscal mechanism of public sector wage restraint". Figure 18 provides a diagram visualisation of the elements which compose the mechanism. Through this theoretical mechanism it is possible to account for the causal chains behind the production of public sector wage restraint observed in both the 1990s and 2000s. The causal process which the mechanism describes unfolds as follows.

At the beginning of the causation chain there is a fiscal event which, by reducing the public employers' available fiscal space, reduces their ability to pay and increases the need to pursue a policy of wage restraint. By fiscal event I mean an event, of whatever nature, which has fiscal significance (Schumpeter 1918). This means that by inducing a deterioration of the public budgets (via higher expenditures, lower revenues, or a mix of both) it is of causal significance for it urges the necessity to act upon the composition of the budget (i.e. either raise more revenues or cut expenditures).

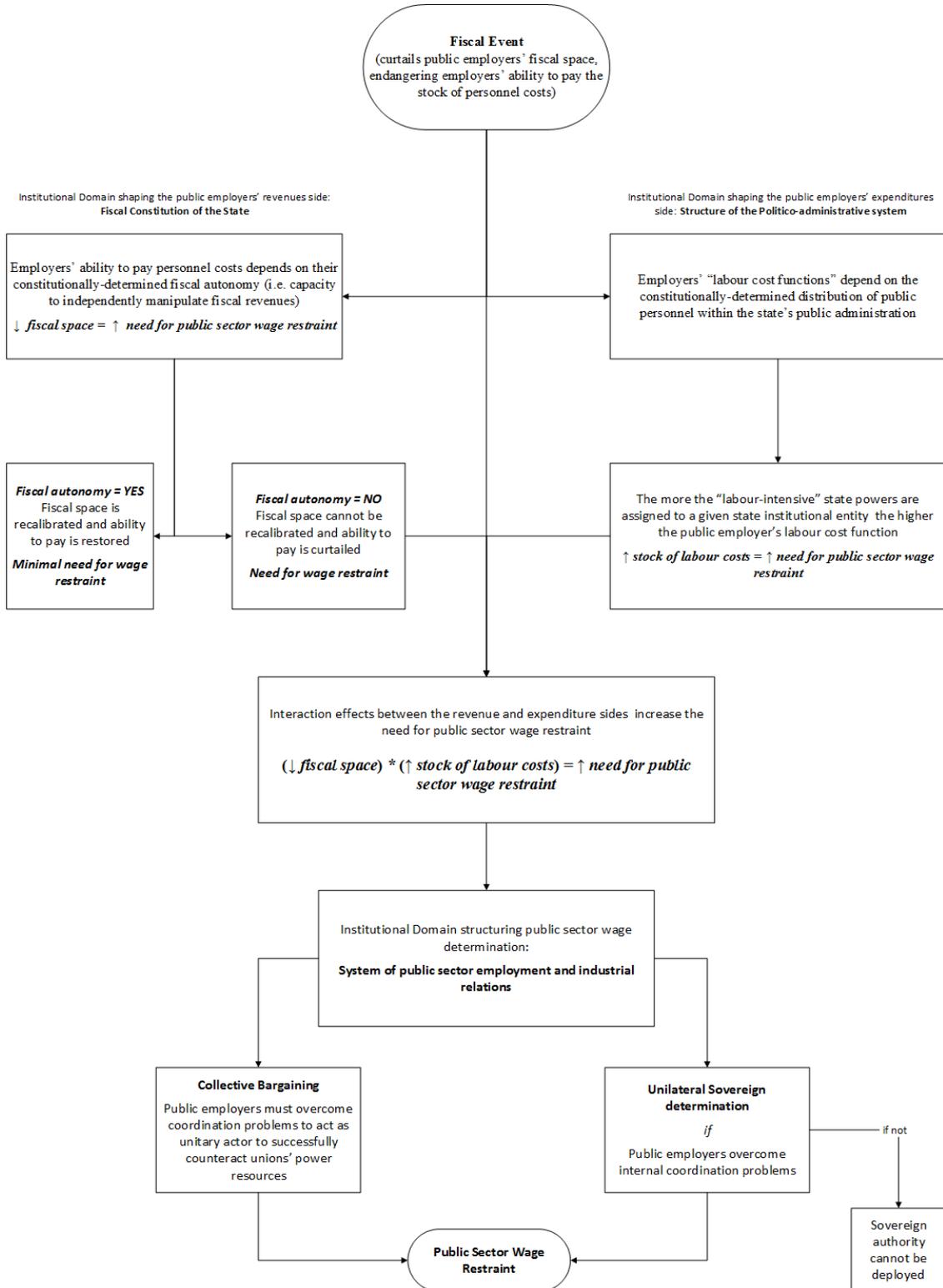
The restraint process, however, is shaped by the institutions of the state which regulate the public employers' revenues and expenditures' sides. On the revenues' side, the crucial causal factor is the public employers' fiscal autonomy, i.e. the legal capacity to manipulate tax revenues at will. The logic is straightforward. Were fiscal autonomy available to the public employers, their ability to pay could be restored by manipulating the revenues' side. Were this to be possible, the very necessity to pursue a policy of public sector wage restraint would be reduced in the first place. If this is not the case, like in the German fiscal federalism system, public employers must act on the expenditures' side. Here, what matters is the distribution of public personnel within the institutions of the state. This is determined by countries' constitutions, written or unwritten. When a fiscal event reduces the public employers' fiscal space, in the absence of the fiscal autonomy necessary to restore it, there is an institutional interaction effect between the expenditures and revenues sides. The necessity for fiscal consolidation becomes exponentially salient for those public employers with higher stocks of labour costs in their organisations' books. Two institutionalist working hypotheses can be derived which have wider implications beyond the German case.

First, within the scope conditions of an institutional configuration equivalent to that just described, we should expect these public employers subjected to high stocks of labour costs to be at the forefront of a policy of firm fiscal consolidation. Given the incidence of labour costs on total outlays, public sector wage restraint will constitute a major (yet most likely not the only) component of this strategy. Second, when a fundamental asymmetry in the distribution of personnel costs within the administration of the state exists, we could very plausibly expect conflicts of interests to emerge within the public employers' camp. This becomes increasingly more likely if the competences for which they are responsible are not adequately matched by the necessary fiscal autonomy, like in the German constellation.

But for a wage policy to be adopted, it must be enacted through the system of employment and interest representation. There are two fundamental ways in which public sector wage setting can be regulated. In collective bargaining the public employers, although state actors, have to go through independent negotiations with the trade unions. Failing to do so would expose them to judicial review vis-à-vis those other state institutions in charge of checking and balancing the public employers' sovereign prerogatives. Within the context of collective bargaining, public sector wage setting then becomes a game of power vis-à-vis the trade unions whose outcome is difficult to predict *ex ante*. On the other hand, if the legal system prescribes a public sector employment relations system based on public law, the state can act as a political sovereign and regulate the terms of labour via unilateral legislation. However, the state's sovereign prerogative, while absolute *de jure*, is rather contingent *de facto*. Public employers' sovereign authority is contingent on two factors: unilateral action must be prescribed by the legal system and public employers must overcome problems

of internal coordination in order to exercise sovereign authority in public sector industrial relations.

Figure 18: The fiscal mechanism of public sector wage restraint



These are the general constitutive elements of the causal mechanism which I have observed in the case study. It must be stressed, however, that *I do not claim* this to be a causal mechanism that can be fully generalised to explain all sorts of public sector wage policies. On the contrary, such an explanatory mechanism cannot travel beyond the scope conditions of policies of public sector wage restraint. This mechanism is not likely to explain fully the other two types of public sector wage policies identified in chapter 1. To understand what drives policies of public sector wage inflation and policies of the golden rule, further research is needed. Within the context of the EMU, two very interesting cases are France and Italy.

France is the case study from where to start in order to investigate the pursuit of public sector wage policies more or less in line with the golden rule. What we know about the French case is that the French Ministry for the Economy and Finance plays a prominent role in drafting the legislation which determines public sector wage policy. It would be interesting for future research to explore what types of political conflicts emerge within the context of a unitary and more centralised and powerful state like the French one. Italy is instead the case study from which to start to study policies of public sector wage inflation. To “isolate” the politics of public sector wage/fiscal policy proper from other confounding/environmental factors, Italy should be preferred over Ireland and Spain. This is because both Ireland and Spain are cases in which public sector wage inflation occurred in conjunction with simultaneous housing bubbles. This may have contributed to exert upward pressures on wage setting across the economy. Italy is thus a better case in that it experienced public sector wage inflation in the absence of a housing bubble.

Insights from the public choice school of thought may be useful starting points to arrive at an explanation of Italy’s trajectory of public sector wage inflation. These theories would interpret public sector wage/fiscal expansion as the by-product of self-interested politicians’ quest for electoral gains and political consent. Without any pretention to imply that all politicians are malevolent at all times and in all places, preliminary research on the Italian case (Di Carlo 2018b) points at the fruitfulness of exploring further the public choice hypothesis. Within the Italian context, the public employers were also internally divided on public sector wage policy, but given the different institutional configuration of the state, this division took a different form.

During the period of public sector wage inflation before the crisis (figure 3), Italy was ruled by a centre-right coalition under the aegis of Silvio Berlusconi’s *Forza Italia* party. What characterised that government was that, to govern within the proportional electoral system, Berlusconi had to rely on the support of the Northern League (*Lega Nord*) and that of post-fascists (*Alleanza Nazionale*) and neo-Christian-Democrats (*Unione di Centro*). The former party is (or better “used to be” given the most recent developments in Italian politics) primarily a political representation of the productive classes rooted in the Northern part of the country. The other two parties constituted instead a political bloc representing the so-called *Destra Sociale* (“the right with a

social soul”) which stood in representation of the lower middle classes of the Southern part of the country. Peculiar to the Italian context is the fact that public sector employment and wage policies therein have been historically used as a socio-economic stabiliser to support the local poorer and backward economies in the South (Cassese 1977; Santoro 2014). Public sector wage policy in Italy has for long time worked as a form of hidden fiscal transfers to redistribute resources toward the South (Alesina, Danninger, and Rostagno 2001).

The politics that produced public sector wage inflation in Italy was of a different nature than that which took place in the context of Germany’s restraint. The Italian dynamic resembles more the formation of those “distributive coalitions” described by Olson (1982). Within the system of public sector employment relations in Italy, the fiscal resources necessary to give ARAN<sup>27</sup> the mandate to negotiate with the unions were decided by the central government. According to the procedure, the budget laws allocated the fiscal resources before the bargaining season would start. This institutional configuration created the paradoxical situation whereby all the parts involved in negotiations knew the exact amount of the resources the government had allocated for public sector wage setting before even meeting. Negotiations would thus *de facto* occur not on the *quantus* of the resources but only on how to distribute the money. A political cleavage emerged within the two blocs which composed the coalition government. The Northern League, of which the Finance Minister Giulio Tremonti was expression at the time, opposed the allocation of generous resources for public sector wage policy. The “Southern bloc” represented by the deputy prime minister Gianfranco Fini (*Alleanza Nazionale*’s leader) made more generous pay settlements in the public sector a central component of their political strategy targeted to their Southern constituency. Gianfranco Fini built up a “public sector’s cross-class coalition” with the leader of the CISL trade union, historically strong and highly representative in the public sector. Supported by the unions and thanks to his rising political strength within the government, Fini defeated the Finance Minister Tremonti in a series of harsh intra-coalitional conflicts, eventually forcing Tremonti to resign. Public sector wage inflation in Italy during those years was the result of a precise and strategic political choice by a part of the public employers in government. The deputy Prime Minister Fini formed a political coalition with the unions and mobilised political capital within the government to successfully expand the resources earmarked in budget laws to disburse more generous wage increases in the public sector contracts. This strategy, however, could not continue when the financial crisis (a fiscal event)

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<sup>27</sup> ARAN is an independent agency which was created after the 1993 “privatisation” of public employment’s legal status and the reform of the wage determination system in the public sector. The agency is linked to the central government through a principal-agent relationship. It represents the government in its function of public employer and in processes of public sector wage setting. ARAN was created exactly to “depoliticise” public sector wage setting, a long-lasting plague of the Italian political system (Talamo 2009).

blew up, reducing the public employers' fiscal space and triggering the need for the government's fiscal consolidation.

Thus, although through different mechanisms than those identified to explain Germany's restraint, the Italian case seems to confirm a central claim which this dissertation highlights: public sector wage policy is fiscal policy and, as such, cannot be comprehended meaningfully without studying the politics of fiscal policy. This insight has wider implications for CPE. The hope is that this dissertation will contribute to bring the public sector within the radar of CPE scholars. This should hopefully trigger an interest for the so-far neglected role of the public employers as state actors.

By having shown the weaknesses of the pattern bargaining hypothesis, this dissertation calls for a reconsideration of a wider set of works which have ignored the fiscal and political nature of public sector wage setting and the crucial role the state plays in industrial relations. As the literature review suggested, this seems to be a "structural weakness" of the CPE literature which, with notable exceptions, has been prominently characterised by an export sector bias. CPE scholars involved in the recent "growth models" turn (Baccaro and Pontusson 2016) may find some of this dissertation's insights interesting for their newly-established research agenda.

When it comes to the politics of growth models, this dissertation suggests that state actors are no subaltern to producer groups' coalitions in the export sector. To be sure, the growth models research agenda is still in its infancy and much will hopefully come out of it. Yet, for the moment being, the interpretation given of the German case is not so different from the standard understanding of the German political economy as functioning with an export sector elite at its core. A mainstream story is being told from a demand-side perspective. What has been added, and which remains anyway highly controversial, is that:

*"German export firms, by virtue of the price sensitivity of their products, were less willing to concede to the wage claims of their own employees and also pushed much harder than Swedish export firms to ensure that wage increases in the export sector would not spill over into economy-wide increases in labor costs" (Baccaro and Pontusson 2016, 197).*

In fact, the inference being made with regard to the functioning of the German growth model can be conveniently represented through the following syllogism:

- (a) *Export sector's firms whose products are price sensitive need to maintain the economy's REER competitive (i.e. undervalued vis-à-vis its competitors) (p. 189).*
- (b) *An economy's REER is maintained undervalued through the "strategic" repression of an economy's wage increases and consumption patterns (the combination of which ensures lower ULCs and prices' inflation) (p. 189).*
- (c) *The products of Germany's export firms are price sensitive (p. 190).*
- (d) *Ergo, the pattern of wage restraint observable throughout the German economy is a by-product of the export firms' necessity to maintain an undervalued REER (p. 197).*

But how could export sector wage setters possibly “push much harder” to enforce wage restraint in the other sectors of the economy? Through which institutional/legal mechanism do export sector elites dominate the other constitutive actors of the German political economy? This fundamental point is still unclear in this research agenda. This dissertation suggests export sector elites do not and cannot easily capture the political arena as claimed. To the best of my understanding, it seems to me that at the heart of these scholars’ interpretation of the German case there continues to be a functionalist type of “repressive” inter-sectoral wage coordination based on export-led pattern bargaining. The findings of this dissertation bear some insights which may help growth models’ scholars to proceed ahead without falling prey to the export sector bias which characterises CPE.

A central theme, very dear to historical institutionalists, is that policy outcomes may often be the result of *unintended consequences* rather than *intelligent design*. Within given institutional constellations, policies pursued for other purposes may often produce outcomes which were not in the original intentions of the policy actors who have produced them. This observation is a pertinent starting point. In fact, unless and until it will be shown empirically and convincingly *how* the export sector elite captures all the other relevant policy actors and successfully imposes wage restraint across the other sectors of the German economy, there will always remain a fundamental missing link in their arguments. This undermines the credibility of these accounts as much as that of similar accounts which, before this new paradigm, provided similar functionalist explanations based on supply-side reasoning. Until recently, in fact, it was common to believe that the institutional link, i.e. the “spillover mechanism”, which ensured the transmission of wage restraint from the export to the sheltered sector was export-led pattern bargaining. This dissertation has shown this not to be the case anymore. Furthermore, this dissertation has made the case that such a capture of the political arena by export sector interests may not be so easy in a fragmented and decentralised state like the German one.

Of relevance, the dissertation shows instead that public sector wage setting in Germany had its own logics and unfolded within its own institutional configuration. Public sector employers, as state actors, were not neutral actors. Neither were they co-opted by export sector’s wage setters. In disagreement with these export-sector-centred accounts of German industrial relations, the dissertation has shown that rather the contrary occurred. Especially during the 1990s, there were instances in which the pay settlements which militant unions in the export sector managed to extract against their metalworking employers were damned by the public employers. The public employers were struggling already for themselves to impose wage restraint to achieve fiscal consolidation. Generous pay settlements in the export sector created imitative spill-overs and political pressures on the public employers forcing them to revise upward their initially meagre offers. The historical reconstructions show that the public

employers had their own problems to care about and that these problems were primarily of a fiscal nature.

Thus, Germany's public sector wage restraint was "unintended" if by "intentional" it is meant (as more or less implicitly assumed in this and other related scholarly literatures): the strategic pursuit of wage/fiscal restraint as an intentional strategy for engineering an undervalued REER which underpins a clearly defined and understood growth model. In this sense, the making of the German export-led growth model is partially unintended. While, legitimately, export sector actors were and are interested in their export competitiveness, there was/is no legal/institutional way in which they could impose wage restraint on the public sector. Thus, rather than intelligent design, the German growth model today is partially the reflection of yesterday's public employers' need for fiscal consolidation. This need for consolidation was partly induced and partly shaped by the fiscal and political institutions of the German state. Thus the takeaway of this dissertation for scholars interested in understanding growth models is that we cannot avoid taking seriously the causal role state structures play in the adoption of given (macroeconomic) policies.

Additionally, an important takeaway is that the public sector matters and is not a mere satellite of the export sector. Most of this literature refrains from talking about the public sector and only considers wage restraint in the low-end services (e.g. retail trade, hotels and restaurants, other personal services). But this is hard to comprehend. Why should we expect inflationary pressures to emerge in a sector in which the labour force is characterised by precarious, non-unionised workers, often with immigrant origins or other sorts of poor backgrounds? The segment of the sheltered sector which matters for the politics of public sector wage inflation is rather the public sector, an insight which is well understood by Hancké (2013). As a result, the public sector and the state deserve a better standing and a more central role in the way we are rethinking CPE.

When studying the German political economy in future research, growth models scholars may want to consider the fact that the low-wage institutional equilibrium which has been identified in public sector wage setting constitutes a central component of Germany's overall industrial relations system. *De facto*, what it does is to work as a *functional equivalence* to what used to be the pattern bargaining mechanism or the Bundesbank's signalling game. It prevents inflationary developments in the single biggest and most politically relevant of Germany's sheltered sectors. Public sector wages in Germany do not grow inflationary because of the peculiar type of joint decision making which characterises Germany's public sector wage setting system. This creates a low-wage trap which delivers benefits to all the public employers involved. An alteration of the German fiscal federalism system in the direction of attributing greater fiscal autonomy to sub-national governments looks like the most promising way to create the conditions for a way out of the *status quo*. This, however, requires a process of constitutional reform which is likely to be blocked by those veto

players who currently benefit the most from the “partially-competitive” system of public sector wage setting in Germany, i.e. the richer Länder.

In all, if my findings are correct, this dissertation cannot but end with a negative message to all those academics and policy makers who have been encouraging Germany to do more to contribute to a more symmetric macroeconomic adjustment in the EMU. To do so, it is generally argued, Germany should inflate its economy beyond its EMU trading partners’ through the combination of more expansive fiscal and wage policies. This will contribute to reduce Germany’s über-competitiveness and will support higher demand for imports by German citizens. Without entering the debate on the merits and desirability of such a theorized macroeconomic mechanism, this CPE dissertation is a reminder to macroeconomists that the adoption of macroeconomic policies is contingent on the institutional setting within which policy actors interact to produce them. Alas, the farewell message of this dissertation to policy makers is negative. Germany’s institutional capacity to adopt inflationary wage policies in the public sector is constrained by the structure of its “semisovereign” system of governance characterised by a fragmented polity, consensus-based politics and a rigid fiscal federalism system. As long as this low-wage institutional equilibrium remains in place within the German political economy, there is currently no political agency which has the intention and the institutional/legal capacity to push through a policy of public sector wage/fiscal inflation which would contribute to relieve the EMU from its sorrows.

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## APPENDIX A: LIST OF INTERVIEWEES

*Table 4: List of interviewees*

	Type of Interview	Institutional affiliation	Date	Place	Comments
Interview 1	Elite	DGB	10/3/2016	Cologne	
Interview 2	Elite	Ver.di	1/4/2016	-	Questions answered via email
Interview 3	Elite	Ver.di	11/4/2016	Berlin	
Interview 4	Expert	University of Heidelberg	2/12/2016	Heidelberg	
Interview 5	Elite	ETUI	6/12/2016	Brussels	
Interview 6	Elite	EPSU	6/12/2016	Brussels	
Interview 7	Expert	WSI	9/12/2016	Düsseldorf	
Interview 8	Expert	-	13/12/2016	Geneva	The interviewee held different positions in the German Finance Ministry, in academia and in think tanks
Interview 9	Elite	DGB	4/1/2017	Berlin	
Interview 10	Elite	GEW	10/1/2017	Hennover	
Interview 11	Expert	University of Bremen	11/1/2017	Bremen	
Interview 12	Elite	Ver.di	19/1/2017	Berlin	The interview was a round table with n.3 officials in the top echelon of Ver.di
Interview 13	Expert	DIW	20/1/2017	Berlin	
Interview 14	Expert	Technical University of Kaiserslautern	23/1/2017	Kaiserslautern	
Interview 15	Expert	FATK	24/1/2017	Tübingen	
Interview 16	Elite	GEW	25/1/2017	Frankfurt	
Interview 17	Expert	University of Heidelberg	26/1/2017	Heidelberg	
Interview 18	Elite	Ver.di	3/2/2017	Berlin	
Interview 19	Elite	Dbb	7/2/2017	Berlin	
Interview 20	Elite	Dbb	15/3/2017	Berlin	
Interview 21	Elite	Federal Finance Ministry	10/4/2017	Berlin	
Interview 22	Elite	Bavaria's Economics Ministry	3/7/2017	Munich	
Interview 23	Elite	TdL	19/7/2017	Berlin	
Interview 24	Elite	Dbb	20/6/2017	Berlin	
Interview 25	Elite	TdL	24/7/2017	Dresden	
Interview 26	Elite	VKA	24/10/2018	NRW	Precise address anonymised
Interview 27	Elite	"NRW Government's Commission on "the future of the public sector"	26/2/2019	-	Questions answered via email

## APPENDIX B: DATES OF THE SIGNATURE OF SELECTED SECTORAL COLLECTIVE BARGAINING AGREEMENTS

*Table 5: Dates of the signature of selected sectoral collective bargaining agreements, Germany (1991–2016)*

<b>Year</b>	<b>Public Sector</b>	<b>Metalworking sector</b>	<b>Chemical sector</b>	<b>Pilot agreement</b>
1991	March 16	May 5	June 20	<b>Public sector</b>
1992	May 7	May 17	June 24	<b>Public sector</b>
1993	February 4	–	–	<b>Public sector</b>
1994	March 11	March 5	January 11	Chemical sector
1995	May 3	March 7	March 9	Metalworking sector
1996	June 13		March 29	Chemical sector
1997	–	December 15, 1996	December 9, 1996	Metalworking sector
1998	March 27	–	May 9	<b>Public sector</b>
1999	February 27	February 18	May 31	Metalworking sector
2000	June 23	March 28	March 22	Chemical sector
2001	–	–	–	–
2002	–	May 18	April 18	Chemical sector
2003	January 10	–	May 8	<b>Public sector</b>
2004	–	February 12	May 14	Metalworking sector
2005	TVöD – February 9	–	June 16	<b>Public sector</b>
2006	TV-L – May 9	April 22	–	Metalworking sector
2007	–	May 4	March 4	Chemical sector
2008	TVöD – March 31	–	April 16	<b>Public sector</b>
2009	TV-L – March 1	November 12, 2008	–	Metalworking sector
2010	TVöD – February 27	February 18	March 21	Metalworking sector
2011	TV-L – March 10	–	March 31	<b>Public sector</b>
2012	TVöD – March 31	May 19	May 24	<b>Public sector</b>
2013	TV-L – March 9	May 14	–	<b>Public sector</b>
2014	TVöD – April 1	–	February 5	Chemical sector
2015	TV-L – March 28	February 24	–	Metalworking sector
2016	TVöD – April 29	May 13	June 23	<b>Public sector</b>

*Source: Author's elaboration, data from the WSI-Tarifarchiv.*



## **Declaration of Academic Honesty**

“I hereby declare in lieu of an oath that this dissertation is my own work and that I have not used any sources other than those listed in the bibliography. Statements, data and concepts taken directly or indirectly from other sources are indicated as such along with the source. The persons listed below assisted me in the way described for each case for a fee/free of charge (underline as appropriate) with the selection and evaluation of the following material: No other persons were involved in the production of the content of this dissertation. In particular, I did not avail myself of the paid assistance of advisory service providers. No one received payment in kind from me directly or indirectly for work connected to the content of this dissertation. The dissertation has not been submitted in the same or similar form to any other examination authority in Germany or abroad. I declare that, to the best of my knowledge, I have said nothing but the truth and have not concealed anything.”

Cologne, 27.03.2019

*Donato Di Carlo*

# Donato Di Carlo

*Doctoral Researcher – Max Planck Institute for the Study of Societies (MPIfG)*

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## Current Position and Previous Education

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2015 - to present

*Doctoral Researcher (4-years contract)*

- *The International Max Planck Research School on the Social and Political Constitution of the Economy (IMPRS-SPCE), Cologne*
- PhD Research Project: “*Unions, Public Employers and EMU: Understanding Wage Dynamics in the German and Italian Public Sectors*”
- Supervisor: Prof. Martin Hoepner
- Advisory Committee: Prof. Berndt Keller, Prof. Christine Trampusch, Prof. Fritz Scharpf

09/2017 – 04-201

*Visiting Researcher*

- *European University Institute, Florence.*
- Supervisor: Prof. Dorothee Bohle

2014 - 2015

*Advanced Master in Public Policy and Social Change (MAPS)*

- *Collegio Carlo Alberto, Turin (IT) - Joint Double Degree with the University of Turin.*
- Dissertation: “*The Political Economy of concertation in the consolidation States of the EMU. Ireland and Italy amidst the financial crisis.*”
- Supervisor: Prof. Margarita Estevez-Abe.
- Grade: *110/110 summa cum laude*

06/2015 – 08-2015

*Visiting Researcher*

- *Swedish Institute for Social Research (SOFI), Stockholm.*
- Supervisor: Prof. Michael Tahlin

2013-2014

*MSc Political Economy of Europe*

- *London School of Economics and Political Science, London.*
- Dissertation: “*Hard times for social partnership in the EMU. A discursive institutionalism approach to the Irish and Italian response to the sovereign debt crisis.*”
- Supervisor: Prof. Kevin Featherstone.
- Grade: *High Merit*

09/2011-02/2012

*Erasmus LLP*

- *University of Bucharest, Bucharest (RO)*

2010-2013

*BA Political Science and Government*

- *Università Degli Studi di Teramo, Italy.*
- Dissertation: “*Post-industrialisation dynamics: The Shift Toward the Service economy. Italy in comparison with selected OECD Countries*”
- Supervisor: Prof. Giovanna Morelli.
- Grade: *110/110 summa cum laude*

## **Scholarships, Activities, Awards**

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- Workshop: Rome Model United Nations (UN MUN), World Bank Committee (03.2013).
- Volunteering with *CARITAS* Torino (2014/2015), integration of immigrants.
- 1<sup>st</sup> student to graduate from class 2010 (07.2013) and *Cum Laude*.
- Full tuition waiver as distinguished student for attending MAPS program at Collegio Carlo Alberto.
- Among top 1% students at Collegio Carlo Alberto and degree *Cum Laude*.
- IELTS Certification, 3/2013 (7.5)
- *STATA ECONOMETRICS WINTER SCHOOL 2015, Porto, Porto Business school (Data Management and Regression analysis (OLS, GLS); IV and Panel Data Models; Discrete Choice Models; Count Data Models)*
- *ECPR WINTER SCHOOL 2016, Bamberg.* Advanced Process Tracing Methodology with Professor Derek Beach
- Full scholarship from the *Ford Foundation* to attend the *MINSKY SEMINAR 2016 at Levy Economics Institute at Bard College (NY)*, foundations of post-keynesian macroeconomics (June 2016)

## Languages and IT Skills

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- *Italian* (native), *English* (full written and oral proficiency), *Spanish* (fluent), *German* (basic)
- Windows/linux OS (Expert), MS Office (Advanced Word, Excel, Access, Power Point), PREZI
- Softwares for data analysis: R (intermediate), EXCEL (full proficiency), Fs/QCA, Logic Friday (intermediate), STATA (basic)

## Presentations at international Conferences

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- June 2017: The 24th International Conference of Europeanists (CES), Glasgow
- July 2017: SASE Conference, Lyon
- March 2018: The 25th International Conference of Europeanists (CES), Chicago
- June 2018: German-Italian Centre for Academic Excellence, Villa Vigoni, Italy

## Publications

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- Donato Di Carlo, “*Does Pattern Bargaining Explain Wage Restraint in the German Public Sector?*”, MPIfG Discussion Paper 18/3. Cologne: Max Planck Institute for the Study of Societies, 2018. [>>more](#)

## Ongoing projects for papers

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- *Matias Dewey and Donato Di Carlo, "Non-enforcement as informal pact: The political economy of law violation in Italy and Argentina"* – Status: Reject & Re-submit in Politics & Society.
- Fabio Bulfone and Donato Di Carlo, “*Banking for Growth: the role of Cassa Depositi e Prestiti in the political economy of post-crisis Italy*”, case study on Italy as part of the FEPS project “*The Rise of Promotional Banks in Contemporary Europe: Potentials and Pitfalls*” run by Daniel Mertens and Matthias Thiemann – Status: paper presented at Sciences Po in October 2018, end of the project June 2019.
- Donato Di Carlo, “*The politics of public sector wage setting in Ireland and Italy: Understanding public sector wage inflation during EMU’s good times*” – Status: ongoing, to be submitted in Spring/Summer 2019.

- Donato Di Carlo, *“The Political Economy of Public Sector Wage Setting in Germany and Italy”* – Status: to be published soon in a volume edited by Christian Joerges and Josef Hien, Robert Schuman Centre for Advanced Studies, European University Institute.
- Benjamin Braun, Sebastian Diessner, Donato Di Carlo and Maximilian Duesterhoeft, *“Central Banks, Phillips Curves and Private/Public Sector Wage Setting in the Era of Low Inflation”* – Status: ongoing research project to be presented at Max Planck Conference on the “Political Economy of Public Sector Wage Setting in Europe”, September 2019.

### **Teaching Activities**

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*University of Cologne and Cologne Centre for Comparative Politics: BA course, “The Political Economy of Southern European Capitalism”, to be taught together with Dr. Fabio Bulfone during the Summer Semester April 2019 – July 2019.*

### **Conferences Organised**

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*September 2019: “The Political Economy of Public Sector Wage Setting in Europe”, at Max Planck Institute for the Study of Societies”, Cologne, Germany.*

*I certify that the statements made by me are true, complete and correct. I also certify that any documentations provided in support of my application are authentic and accurate. I understand that any false or misleading statement or withholding relevant information may provide grounds for the withdrawal of any offer of appointment or the termination of employment.*