

# **Balancing Public and Private Control: Germany and the United States in the Post-War Era**

## **INTRODUCTION**

Every country strikes a balance between public and private control over its institutions, resources, and citizens. Whatever the area of economic concern—employment, growth, the environment, the development of natural endowments, education and training, the financial system, the structure of business enterprises, or public goods provision—the government takes some part in determining the structure of the society’s institutions and the regulation of their activities. What is left falls naturally into private hands. The resulting balance between public and private control depends largely upon the political system and the legal framework in place; that is, the process by which power is ceded to or taken by governmental authorities. That system of governance depends in turn upon the society’s values and the way its citizens perceive their opportunities and challenges.

In political systems that lean toward the socialist paradigm, the public sector has often dominated the private sector in many arenas of economic and social importance. For example, in many European countries, labor policies are often dictated by the central government, so that business is tightly constrained in its dealings with workers and labor has a substantial voice in corporate governance. Similarly, many such governments operate national systems for pensions, education, and healthcare—often to the near (or even complete) exclusion of the private sector. By contrast, countries with a more laissez faire tradition, more often reserve the provision of vital services to private institutions and then guide their operations with regulations, incentive schemes, and judicial intervention. The state offers pension funding and health services as a social safety net

rather than as the primary provider, and it provides education, particularly higher education, as a supplement to widespread private initiatives—often as an agent of social change or wealth redistribution. Seen in Weberian terms as pure types, these two systems often differ markedly in their views on market exchange. Systems leaning toward the socialist model commonly restrain markets based on the notion that a central planning authority will allocate resources more fairly and perhaps even more effectively, enabling the society to reach its highest potential insofar as the welfare of the entire population is concerned. Systems that lean toward a relatively unrestrained form of capitalism favor free market solutions, trading off distributional equity and security under the assumption that markets or endogenous, private institutions will achieve higher levels of innovation and will allocate resources more efficiently over the long-term.

The balance of public and private control that a society chooses is very likely to influence the effectiveness and efficiency of its institutions, the distribution of resources and outputs to its citizens, and the overall rate of expansion of its economy. In some cases, government control may provide the best, or even the only, means by which certain goods or services may be produced. When the public good component is significant— as it is with the military, fire fighting, or mass transit, for example—the government can often provide the best solution to market failures.<sup>1</sup> In other cases, private control provides the most efficient allocation of resources and promotes individual action for a greater overall gain. Business enterprise and financial institutions, for example, usually function most productively and efficiently under private control.

Because political institutions in modern democratic societies tend to respond more slowly than private, market-oriented organizations to changes in their economic and technological

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<sup>1</sup> Market failure describes a situation in which private markets will not produce the goods or services society needs at a price that most citizens can afford (mass transit). This condition also exists where sustained investments and the development of organizational capabilities that are used infrequently (the military and fire fighting) are needed to protect the society as well as individuals.

environments, the balance between public and private control becomes a crucial factor when major economic transitions take place. The shift, for instance, between the first and second industrial revolutions imposed new demands upon each developed society's basic institutions. So too – and doubtless to greater degree – with the transition from the second to the third industrial revolution, that is the information age revolution of our time. Each of these momentous transformations spawned sustained struggles over the desirable balance between market control and governmental control, between centralized direction and decentralized decision-making. Each launched sustained experiments in control, a process that is continuing to today throughout the world.

The struggles over control are fierce because the tradeoffs between the public and private sectors touch the purses and lives of almost every citizen. The distribution of assets or cash-flows is a gut issue everywhere in the world. People do not have to be told that equity and security matter. Governments frequently find it necessary to intervene in freely-functioning markets in order to protect less powerful citizens from those with superior information: regulating medical licensing, controlling the financial system's institutions and operations, and establishing the basic rules for corporate governance, for example. Similarly, governments provide education and training in part to ensure more equitable distribution of goods and services as well as to ensure that the society will have the expertise it needs to remain competitive. Whether or not a market failure is perceived, and how severe or problematic such failure appears to the public, differs markedly within and between countries.

Our book focuses on the evolving balances between public and private control in two of the most important economies in the modern world. Because both of these societies are very large and incredibly complex, it is both desirable and difficult to characterize the balance each has achieved without descending into journalism. Some phenomena resist simplification and dramatization for good reasons. Still, we believe the effort to characterize and compare the patterns of institutional development in Germany and the United States in the years since World War II is important to scholars and to all those concerned about the dramatic changes that have taken place in the global political economy in recent decades.

The comparison in this case is interesting because it offers an opportunity to study significant institutional differences while holding certain characteristics relatively constant. The two economies look a lot alike in the global context of successful nations and they have similar long-term patterns of development. They are and have been for more than a century among the largest, most advanced economies in the world. They followed similar paths to industrialization over the latter half of the nineteenth century and the first three decades of the twentieth. Even since the Great Depression of the 1930s and the Second World War, the two countries have remained on similar economic footing compared to most of the rest of the world. Both transitioned through similar stages of industrialization based on textiles, steam engines, railroads, iron and steel. Both became leaders in Second Industrial Revolution industries, including chemicals and pharmaceuticals, electricity and electrical engineering, and on to internal combustion engines and aeronautics. Although their timing was different, both countries developed sophisticated financial systems, built up elite educational institutions, and created a complex to promote science and technology-based innovation. Quantitative measures show remarkable parity in output, productivity, and innovation (relative to the size of their respective populations) over the last century and a half. And both countries maintained

high standards of living and a strong cultural emphasis on material progress. The relative positions of the two countries have shifted back and forth over time, but their long-run standing among the world economies remains in a similar range.

Looking beneath the surface of national income accounting and general descriptions of institutional development, however, there are substantial differences in the structure and functioning of German and U.S. political, economic, and legal institutions. They have followed divergent paths in arriving at their current positions. One of the most fundamental axes along which the two countries differ is the tradeoff between public and private control. These disparate tradeoffs are deeply rooted in the two nations' history, political ideologies, and the cultures that have held sway for more than a century: Germany began its experience with social controls in the late nineteenth century and already had a well-developed bureaucracy to implement public programs; the same sort of socialist ideals that took hold in other European countries during the twentieth century had an impact on Germany, especially during the Weimar and post-World War II reconstruction periods. The United States, by contrast, had very limited governmental capabilities and a narrow range of social policies at the federal level through the end of the nineteenth century; in the twentieth century, America finally and hesitantly acquired an administrative state, but the nation's unusual array of economic opportunities and demographic and geographical mobility reinforced American antistatism and a preference for market-oriented institutions. One of those economic opportunities stemmed from America's great abundance of land, and in this case the federal government had little choice but to engage – as it still does today – in the real estate business. Otherwise, however, state-owned enterprises (SOEs) were the exception in the United States until well into the twentieth century.

The differences between American and German political ideologies and cultures have been incorporated into the differing designs the two societies have adopted for institutions with ostensibly

similar goals. In Germany, power flows more readily to the center, while in the United States each effort to centralize authority meets resistance and substantial control of economic activities remains with states and municipalities. In Germany the central government exercises more direct control over the economy's functional units, whereas in the United States, government involvement more typically comes in the form of funding, regulatory restraints, insurance or guarantees, and tax or other financial incentives.

These contrasting patterns can be seen across a wide range of institutions. For example, Germany's educational and academic research system rests almost exclusively in public hands, while the American counterpart uses an unusual combination of private and public institutions, with substantial public funding of private, nonprofit organizations. In Germany, as throughout Europe, the nonprofit sector is relatively underdeveloped. Even when the U.S. and German governments spend similar amounts per capita on education and research, the American activities are much more often carried out through private institutions or through hybrid organizations that are partly public, partly private. Likewise, the German government provides the majority of the nation's retirement funding through its public pension system. In the United States, by contrast, the very poor depend on publicly-provided pensions, but most pension funding for the rest of the population comes from private sources. So too with healthcare and other functions vital to all modern, highly developed societies.

The following essays put some historical and analytical flesh on this skeletal outline of comparative German-American political economy. The authors address a range of topics related to the manner in which Germans and Americans have balanced public and private control, particularly as it impacts the development of business and finance and influences the ability of the two nations to achieve higher levels of productivity and growth. A central concern throughout is the effectiveness

of German and American institutions in introducing new technologies and the public and private organizational innovations essential to economic success in the information age.

The book begins by laying out the legal and political underpinnings of the German and American systems of public and private control. In her presentation at the conference, Colleen Dunlavy demonstrated how the public-private balance evolved over the late nineteenth century and first half of the twentieth century—setting the stage for the institutional change that would unfold following World War II.

Chris Kobrak and Harold James then explore the ownership and control of corporate firms in Germany, contrasting these developments with the patterns emerging in the United States in the decades since the Second World War. Here the authors encounter the dominant historical paradigm of Alfred D. Chandler, Jr., who has stressed the similarities in German and American corporate development. While German enterprise was, Chandler concludes, more inclined to cooperative behavior through cartels, the modern firms in both societies turned quickly and decisively away from family control and embraced professional management. To the contrary, Kobrak and James say, family institutions and values remained important even in big business in Germany. Those values and institutions were favored by the German regulatory system, and they passed the market test, helping firms deal with uncertainty and risk.

Whether managed by professionals or family members, businesses in all societies draw upon the nation's financial markets for the capital they need. In very large, growing economies, like those of Germany and the United States, enterprises typically look to some form of outside finance at some point in their development. With this in mind, Caroline Fohlin hones in on the Schumpeterian question: how is innovation financed at its earliest stages—in many cases, before a new idea is

even marketable or a company sufficiently stable to attract outside funding. Her chapter delves into these issues by comparing the differences in German and American economic, political, and legal systems that have led to very different modes of providing venture capital in the two countries. In this case, Germany has clearly lagged in the past twenty-five years. At the root of the problem, Fohlin says, the German setting produced fewer high-technology entrepreneurs, and those who were involved in high-technology venturing encountered negative incentives to innovation. Germany thus performed well despite the lack of a well-developed venture capital industry until it reached the brink of the information age. Even with recent gains in Germany, she concludes, the current situation remains problematical, as the United States seems to have pulled rather far ahead in the technological boom that began in the 1990s. Disparities in corporate control, financial markets, and venture capital institutions are likely to translate into significant differences in technological innovation and in the productivity increases that are in part a product of new technologies.

Mary O'Sullivan's chapter examines the next stage in the external financing of firms, analyzing the evolution of the U.S. stock market—a composite of several distinctly organized trading markets which serve the American business system. O'Sullivan is particularly concerned with the manner in which new entrepreneurial firms are able to obtain capital – a problem emphasized by Joseph A. Schumpeter and many subsequent authors – and thus to sustain the entrepreneurial drive of the business economy. Despite the powerful myth of the so-called “free market,” O'Sullivan shows us how regulation shaped and reshaped those markets. Digging deeply into the developmental process, the author charts the intended and unintended consequences of the SEC's regulatory regime and the balance between control and competition in the American setting. Competition took place between the trading systems as well as firms, and both had to respond

creatively to the third industrial revolution or give way to more effective rivals, as did the American Stock Exchange.

Ulrich Wengenroth takes up this topic of innovation and competition, and his careful exploration of the technological progress of the two nations brings him a deeply pessimistic conclusion about the outlook for Germany in the twenty-first century. Exploring both the changes that immediately followed World War II and those that came as reconstruction ended and reunification began, Wengenroth explains how and why the productivity gap between America and Europe gradually closed. But information technology (IT) didn't really catch on and the German government was left trying to catch up near the end of the millennium. So too in biotechnology. By a variety of measures, which the author develops with great care, Germany was slipping behind under conditions of technological regime change of the sort experienced from the 1990s to the present.

As Ray Stokes demonstrates, West Germans looked to America for models and ideas in the post-WWII era and successfully blended those concepts with their own historical traditions and uniquely German institutions. That mix helps explain German progress in closing the marked technological and economic gap that existed in the immediate aftermath of the war. This was achieved while Germany was developing a distinctive brand of "social market economy," an economy with strong elements of co-determination, a form of "capitalism with a conscience." This required Germans to redefine the balance between public and private control, an experience that Stokes explores by looking at energy policy in the 1950s and 1960s and deregulation/privatization in the 1960s. In each case, a glance suggests that American concepts were hegemonic, but by peeling back the realities of the new situation, Stokes shows that Germany tailored its policies with an eye toward its own history and toward the emerging European Union (EU). The EU was, thus, an

intellectual and political counterweight to the powerful U.S. system, a conclusion that may well point the way to future changes in the balance between public and private control both in Germany and the United States.