EMPLOYER PREFERENCES AND SOCIAL POLICY: HOW TO EXPLAIN INSTITUTIONAL CHANGE IN GERMAN EMPLOYMENT PROTECTION SINCE WORLD WAR I?

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Abstract:

The paper provides a historical case study of German labor law to address two linked questions of the political economy and institutional change literature: is change of formal institutions a result of exogenous pressure only or are there endogenous explanations as well? And how do functionalist theories about employer interests in social policies perform in explaining the development of institutions (vis-à-vis conflict-oriented explanations)? The results suggest that the trajectory of change was determined by the combined effect of four factors: 1) the impact of contingent events on the power resources of relevant actors, 2) the resulting bias towards employee interests in the formative compromise on dismissal protection, 3) the path dependence of the institution and 4) changed circumstances which made the ‘losers’ of the initial negotiation (i.e. employers) challenge the institutional arrangement. Hence, change partly goes back to endogenous factors, which, in turn, points to the importance of ongoing distributive conflicts destabilizing the institution.
1. Introduction

Labor markets in many developed economies experienced a profound transformation since the oil crisis of the 1970s triggered the demise of an allegedly ‘golden’ age. This seems to be especially true for Continental welfare states which had to escape a vicious cycle of low labor utilization and growing non-wage labor costs. In most cases, the transformation was more successful than predicted by the comparative welfare state literature (Pierson, 1996; Esping-Andersen, 1996); however, it typically came at the cost of new inequalities in the labor market. Germany is a widely discussed example for the dualization following liberal reforms mainly targeted at marginal groups. Since the 1980s, the decline of the German ‘Normalarbeitsverhältnis’ (standard employment relationship) and the corresponding growth of atypical employment have been subject to intense research. But it is only lately that attempts were made to go beyond normative or descriptive approaches and to provide explanations for the peculiar trajectory of change in the German (and Continental) labor market (Clegg, 2007; Eichhorst and Marx, 2009; Palier and Thelen, 2010). Drawing on mechanisms of incremental change (Streeck and Thelen, 2005), this analytically more ambitious work identifies dualization as a possible pathway by which persistent labor market institutions are circumvented. While this gives a plausible explanation for typical Continental reform patterns over the past 30 years, the cited studies suffer from a serious drawback: the analysis is based on an overly short time horizon. Virtually all recent studies on labor market change do not go back further than to the end of the ‘golden age’ in the 1970s. In this perspective, one is tempted to attribute change to the worsening labor market performance caused by external forces such as globalization, societal developments, skill-biased technological change, etc. While this is certainly part of the story, the present paper argues that, in addition, endogenous causes for change must not be neglected.

Institutional change is understood as being endogenous, if it is not (only) caused by the environment of an institution, but has its roots in its initial design. Thus, understanding endogenous change requires knowledge about the emergence of institutions, the formative compromise they represent and the circumstances under which it came into being. To provide an encompassing explanation why German employers increasingly defect from standard employment, it therefore is necessary to ask why its institutions have been created in the first place as well as when and why the point was reached not to support them anymore.

To address these questions dismissal protection - a cornerstone of a stable and secure employment pattern in Germany - is traced from its creation in the inter-war period to the dawn of the crisis in the 1980s. What makes labor law an interesting case study is the collision of various interests. From an economic perspective it is criticized for limiting flexibility, while unions consider it an indispensable protection. As it is also supposed to buttress the traditional German skill regime and with it an entire production model in manufacturing (Estevez-Abe et al., 2001), it exemplifies the contradictory forces fostering pressure for change on the one hand and systemic stability on the other. The paper extracts two approaches from the political economy literature that potentially explain the entire institutional trajectory and, thus, endogenous change. The first one focuses on distributive conflicts between relevant actors, while the second stresses functional interdependencies of labor law and other economic institutions. As elaborated
below (section 3), both approaches provide conflicting explanations for the emergence, resilience and change of dismissal protection. The crucial distinction revolves around the attitudes of employers, i.e. whether they are supportive of dismissal protection or not. After sketching the main institutional developments (section 4), the remainder of the article tests the respective predictions empirically (section 5). The analysis shows that the initial design of dismissal protection was historically biased in favor of unions and that change was largely driven by the contestation of this formative compromise.

2. The Problem: Dismissal Protection and Marginal Flexibility

Since dismissal protection means turnover costs for employers, but social security for employees, it is usually seen as a nuisance for business. However, it can be argued that it involves societal problems as well. Leaving macro-economic issues aside, such as the delayed adaptation to structural change, it directly affects employment prospects of individuals. The question whether and to what extent dismissal protection leads to inferior labor market performance is disputed in the economic literature (for an overview see Blanchard et al., 2006; OECD, 2004). Theoretically and empirically, the effects of dismissal protection on aggregate unemployment are ambiguous, because inflows as well as outflows are reduced. However, with dismissal protection in place employers won’t choose an optimal level of employment, but - depending on the business cycle – either employ too many or to little workers. This makes temporary contracts particularly attractive, since they help to adapt the workforce to a more efficient level in the short term (Boeri and Garibaldi, 2007). In addition, turnover costs improve insiders’ bargaining position and drive wages to a level that hampers upward mobility of outsiders (Lindbeck and Snower, 2001).

Hence, although dismissal protection is usually seen as employee-friendly, it involves a normative problem: it contributes to an uneven distribution of labor market risks between protected and atypical workers. The latter for instance have to accept wage penalties, limited access to training or lower job satisfaction in general (Booth et al., 2002). This is even more problematic as non-standard contracts are not distributed randomly across the labor force. Rather, dismissal protection creates employment barriers for specific groups (i.e. women, younger, low-skilled or migrants) who are excluded from ‘good’ jobs or labor market participation altogether (Kahn, 2007).

The German case is characterized by a comparatively high incidence of non-standard jobs such as marginal part-time, agency work, fixed-term contracts, or freelance. In terms of labor law, this corresponds to an institutional arrangement that features relatively high protection for regular contracts and, by now, quite liberal regulation of atypical work. While dismissal protection has been very stable over time, the past 30 years witnessed an incremental liberalization at the margin of the labor market so that atypical forms of employment gained importance (Eichhorst and Marx, 2009).

The question is why this path of marginal flexibility with its normatively hardly desirable effects was chosen instead of reforming dismissal protection for regular contracts. This is even more in need of explanation as on the international level the contrasting flexicurity concept is increasingly promoted as a best-practice model (European Commission, 2007). In addition, one would expect that “institutions and practices of capitalist political economies can rarely be sustained over time without the active support of at least some
powerful segments of capital” (Hall and Thelen, 2009, p. 11). However, the analysis of employer attitudes towards dismissal protection reveals that the institution is seen as highly dysfunctional. According to recent surveys, approximately 40 percent of German employers refrain from hiring new staff because of dismissal regulation and 67 percent use fixed-term contracts to circumvent it. For large companies the shares are 50 and 80 percent, respectively (Hardege and Schmitz, 2008). Asked for the most important issues to boost job creation the majority of German employers recently stated that reform of dismissal protection should have priority over wage moderation or the reduction of non-wage labor costs. This attitude is most pronounced in the export-oriented industry which is strongly exposed to economic fluctuations (DIHK, 2009).

Although these figures should not be over interpreted, it is safe to say that that dismissal protection – at least presently - does not have much support from business. Against the background of employer opposition and questionable effects in terms of social equity it is the aim of the present paper to explain the institutions’ trajectory of change.

3. Theoretical Considerations: Emergence, Resilience, and Change of Institutions

From an economic perspective, growth of atypical work is easy to explain. In a neo-classical framework, institutions are considered costs. They lead to the deviation from market equilibrium by distorting price- and wage-setting mechanisms. Given a cost differential between standard and non-standard employment, rational employers would only opt for the former, if additional benefits exceed additional costs. But as with marginal liberalization the cost differential grows (atypical work becomes cheaper) and at some point exceeds potential benefits, incremental defection from standard employment would be predicted. This is a plausible (although simplified) account of the effect institutions can have. A more interesting question that the economic perspective has difficulties to answer is why the institutions have developed this way. In its utilitarian and voluntaristic worldview institutions are either exogenous (in which case the approach is not helpful) or they emerge and are reproduced because it lies in the self-interest of actors to solve coordination problems. In this logic a changed cost-benefit ratio should lead to a revision of the institutional tool kit.

There are at least two conflicting theoretical approaches explaining why this may not be so easy. Both make statements on the reasons why institutions have emerged as well as on the mechanisms driving resilience and change, respectively (see Mahoney, 2000 for a similar distinction).

The first perspective can be labeled conflict or power-oriented explanation and is related to the power resource approach and historical institutionalism. It focuses on distributive conflicts between actors and uses power as the central explanatory variable. In this perspective welfare state institutions reflect the relative strength of capital and labor (e.g. Esping-Andersen, 1990; Hacker and Pierson, 2002; Korpi, 1974; 2006). Hence, the foundational compromise between conflicting interests is determined by the capacity of each party to mobilize power resources in order to push through its own preferences. If power is distributed asymmetrically, the institutional output will most likely not be a functionally optimal one, but correspond to the preferences of the strongest actor.

Taking into consideration conflict and asymmetric power also explains why institutions can exhibit resilience. Even if there are actors who would like to alter the status-quo, they
need the power to implement their plans. Thus, the existence of powerful veto players who make change costly is a source of positive feedback or path dependence (North, 1990; Pierson, 2000). Dismissal protection serves as a good example for this mechanism. Once established, the regulation creates its own constituency. Well represented insiders benefit from the status-quo and seek to protect their privileges (Saint-Paul et al., 1996). Such an institutional setting favors the short-term orientation of policy makers who (for electoral reasons) focus on the preservation of the existing institutions (Palier and Martin, 2007). As reforms create immediate costs, while improvements of labor market performance are usually only visible in the long-run, incentives to conduct them are low.

The explanations for institutional emergence and resilience in the conflict-oriented approach correspond to a distinct understanding of change. First of all, change can obviously be a consequence of shifting relative power or of changed preferences (Thelen, 2003). While this means an exogenous factor, Mahoney (2000) stresses that power asymmetries always entail a potential dynamic of endogenous change. Over time, a critical threshold can be reached from which on the disadvantaged group will challenge the established arrangement. If the initial design of an institution becomes too dysfunctional (or benefits too asymmetrical), actors will incrementally defect from it. This means that if foundational conflicts underlying an institution are not resolved, inherent tensions determine the trajectory of change and in most cases lead to a limited durability (Hall and Thelen, 2009; Koreh and Shalev, 2009).

The conflict-oriented approach is contrasted with a functionalist perspective on institutional choice and development. Accordingly, institutions are purposefully designed and stabilized in order to reduce transaction costs or to solve coordination problems. A powerful functionalist argument in the political economic literature is provided by the Varieties of Capitalism approach (VOC) and its claim that complementarities stabilize distinct national models (Hall and Soskice, 2001). An example for a dense network of interdependent institutions can be found in German manufacturing. Its traditional production model - focusing on customization and high-quality – strongly relies on human capital investments that, in turn, require complementary institutions (Streeck, 1997).

According to the VOC approach, dismissal protection is a crucial pillar of this system. Borrowing from transaction cost economics, it is argued that skill specificity creates a ‘hold-up problem’ and that credible commitments to long-term cooperation are necessary. In this sense, the stability-oriented ‘Normalarbeitsverhältnis’ supports the German production model of diversified quality production by encouraging specific human capital investments (Estevez-Abe et al., 2001; Harcourt and Wood, 2007; Iversen, 2005). The functionalist understanding implies a tendency towards resilience, as change in one institution, such as dismissal law, would destabilize the production model. Accordingly, at least in certain segments of manufacturing, employers should be interested in preserving the ‘Normalarbeitsverhältnis’ for efficiency reasons.

But the complementarities keeping an institutional arrangement stable can just as well be the source of (endogenous) change. In a systemic perspective, change in one field can destabilize interdependent institutions, if previously provided positive feedback vanishes. In a densely coupled institutional network, complementarities turning negative therefore may lead to a chain reaction affecting various sectors (Streeck, 2009). In the example of dismissal protection, changes in skills creation and a different production logic in the
service sector could make former complementarities redundant. In that case, employers would be less willing to bear turnover costs and increasingly try to avoid regular contracts.

The most provoking statement by the functionalist approach concerns the emergence of institutions. While there is a tradition in rational choice institutionalism and VOC to treat this question as exogenous (Hall and Theelen, 2009; Weingast, 2002) some authors argue that institutional complementarities are purposefully designed to reap benefits from coordination. In the case of social policy and skill-formation this implies the counter-intuitive notion of employers lobbying for policies or institutions to make a specific production model viable. A well-known example is Mares (2003a; 2003b; 2004) who argues that German employers in skill-intensive sectors were supportive of unemployment insurance to reduce disincentives for specific human-capital investment\(^1\). Although the VOC approach is underspecified when it comes to the emergence of dismissal protection, it appears reasonable to test whether Mares’ argument about unemployment insurance applies, i.e. whether skill-oriented employers showed any support for the institution.

| Table 1: Explanations for the institutional development of dismissal protection |
|-------------------------------------------------|-------------------------------------------------|-------------------------------------------------|
| **Emergence**                                   | **Conflict-oriented**                            | **Functionalist**                                |
|                                                | Employer opposition, outcome reflects the power  | Intentionally designed to back-up skill           |
|                                                | of labor                                        | regime, support by (some) employers              |
| **Resilience**                                  | Political economy of reforms. Employers want    | Complementarity between dismissal protection,     |
|                                                | change, but insiders form a powerful constituency| skills creation and                              |
| **Change**                                      | Contestation by employers (change of relative   | Changes in skill creation and                    |
|                                                | organizational strength, threshold effect)      | production model                                 |
|                                                |                                                 | complementarity redundant                        |

Table 1 summarizes the contradicting predictions of functionalist and conflict-oriented approaches for the development of dismissal protection. The crucial distinction concerns the role of employers. According to the functionalist understanding, employers (at least those who are engaged in quality production) have a preference for dismissal protection and can be expected to play a proactive role in its creation and stabilization. The conflict-oriented approach, however, would argue that employers want to get away as cheap as possible and therefore try to minimize the costs dismissal protection implies. As employers generally oppose the institution, expansion of dismissal protection is explained by the relative power labor has at specific points in time.

It will be the empirical challenge of this paper to test both theoretical predictions on different stages of the institutional development. In order to do this, the analysis will determine employers’ preferences concerning dismissal protection and differentiate between their potential roles as “protagonists, consenters, and antagonists”\(^2\) (Korpi,

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\(^1\) She qualifies this theoretical claim by acknowledging that employers were not agenda-setters in the introduction of the insurance (Mares, 2003a, p. 259).

\(^2\) Three methodological comments are necessary. The first concerns the concept of power. It is beyond the scope of this article to measure the ‘structural’ or ‘instrumental’ power (Hacker and Pierson, 2002) actors can rely on in order to influence political outcomes. The empirical contribution will rather consist in determining the preferences of central actors and in outlining broad factors why they did prevail in the
2006). For the present question it matters whether employers truly supported the institution as a first-order preference or whether they only consented to prevent an even less appealing alternative. Only in the former case, the functionalist argument would be supported.

Admittedly, this is a fairly demanding criterion for the emergence of an institution. Yet, it is a reasonable one for the entire trajectory, since explanations for the various stages can differ. For example, a conflictual creation of dismissal protection is compatible with a functionalist explanation of persistence, if actors adapt their production strategies to the institutional legacy ex-post. As long as complementarities affect employer preferences at some point, this would still be in line with the VOC reasoning.

4. Institutional Development: Periods and Events

The long time period covered by the paper makes it necessary to identify decisive events or periods the analysis can concentrate on. The case of dismissal protection is convenient as a clear starting point can be identified: in Germany the Works Councils Act (Betriebsrätegesetz, BRG) of 1920 represents the first attempt to establish a general and substantial regulation in this area.

Table 2: Periodization of the institutional development

<table>
<thead>
<tr>
<th>Time</th>
<th>Main institutional development and legal changes</th>
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<tr>
<td>- 1914</td>
<td>Liberal regime: virtually no restrictions to the freedom to dismiss</td>
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<tr>
<td>1920</td>
<td><strong>Emergence</strong> of dismissal protection in Works Council Act: Employees can appeal to works council against notice, if it is based on invalid reasons (e.g. not related to personal conduct or situation of the enterprise, based on religion, political affiliation, etc.) (§84). If the plea is considered legitimate and conciliation fails, case can be brought to court (§86). Judicial verification of the appeal does not make the notice null and void. If employer rejects re-employment, worker is entitled to compensation. Severance pay (§87): twelfth part of a monthly wage times years of tenure, maximum half an annual wage.</td>
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<tr>
<td>1951</td>
<td><strong>Restoration/expansion</strong> in Dismissal Protection Act: dismissal in exceptional cases only (§1), individual right to appeal (§3) applicable for companies with six or more employees (§21), social selection criteria (§1), right to re-employment (§7), severance pay up to one annual wage (§8).</td>
</tr>
<tr>
<td>1951 - 1970s</td>
<td>Stability in the context of strong growth, full employment and labor shortage. Incremental emergence of agency work (regulated in Manpower Act of 1973)</td>
</tr>
<tr>
<td>1980s</td>
<td><strong>Marginal reform</strong> in Employment Promotion Act (1985): fixed-term contracts without valid reasons up to 18 months, agency work assignments up to six months.</td>
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</table>

The emergence of the institution is followed by a period with various historical anomalies. The question how the compromise found in 1920 affected the subsequent political process (or why not). Actual ‘channels of power’ are not analyzed. The second point concerns heterogeneity of employers. The analysis is concentrated on peak organizations, which makes sense in a context of corporatist interest representation. This may disguise considerable differences across industries. I therefore focus on positions of the export and skill-oriented sectors that are most likely to be affected by institutional complementarities (and can be seen as a critical case). Third, I do not intend to give an exhaustive overview on the development of dismissal protection. Factual protection against dismissal is determined by a complex composite of various laws, jurisdiction and collective agreements. For the purpose of this paper, I will restrict the analysis to the main regulations in the Works Council Act and the Dismissal Protection Act (see below).
trajectory of change is difficult to answer for that time. In the Weimar Republic, economic turmoil and eventually the rise of National Socialism prevented a ‘normal’ institutional development. It was only after WWII, in a stable democratic environment, that social partners could freely negotiate on the subject and that the institution could unfold characteristics such as ‘lock-in’. Here, three events or periods can be distinguished: the restoration of market-oriented regulation in 1951 (entailing a significant expansion of protection), a rather conflict-free period of stability up to the late 1970s and, eventually, the emergence of a two-tier reform trajectory in the 1980s. Table 2 summarizes the periodization of the analysis.

Before turning to employer attitudes as the core contribution of the paper, the following paragraphs will provide a brief description on how the institution developed over time. In the 19th century, Germany as other European countries did hardly impose any statutory constraints to the right to dismiss. Employers and employees were considered equal parties to a civil contract, which could, in principle, be terminated at any time unilaterally (Hepple, 1986; Stolleis, 2001). The BRG for the first time stipulated that the right to dismiss is conditional upon valid reasons. Although it therefore is historically important as a “Trojan Horse in the citadel of employers’ discretionary right to dismiss” (Vogel-Polsky, 1986, p. 189), in practice, protection on the basis of the BRG was limited. Most importantly, it only applied to companies with works councils, which was only compulsory above the threshold of 20 employees. At that time, this meant excluding an enormous share of the workforce from employment protection (Nikisch, 1951). Furthermore, there was no individual right to go to court, but appealing against notice depended on the consent of the works council (Feig and Sitzler, 1928, p. 226). Another limitation was the lack of compulsory re-engagement. Since the employer always had the choice between re-employment and financial compensation, the freedom to dismiss was still strongly pronounced. Given the very modest level of severance pay (see table 2), this option was in most cases perceived as an insufficient protection against unemployment (Hueck, 1954, p. 17).

The next major change in dismissal protection was brought about by National Socialism. The Act on the Order of National Labor (Gesetz zur Ordnung der nationalen Arbeit, AOG) laid the foundation for the labor law under the NS regime. Practically, however, the regime implemented a state-directed system in which allocation and price of labor could not be determined by private actors anymore. From 1939 on, dismissals or job changes demanded a preemptive check by the public employment service. After capitulation, German labor law turned into an overly complex and fragmented mixture of transitory regulations, improvised jurisdiction, and legislation of the Länder (state) level. For practical reasons, the AOG was later abolished than most other acts of the NS period. After 1947, dismissal protection was regulated either by single Länder or not at all, like in the British zone, where judges used provisions of the civil code to create a practically rather strict system (Fiedler, 2006, chapter 3; Nikisch, 1951). Also, the restrictions on labor allocation remained in place up to 1949 when the Federal Republic was founded. Until then, job changes had to be approved by the employment office (Göller, 1974).

Uniform regulation was restored by the Dismissal Protection Act (Kündigungsschutzgesetz, KSchG) of 1951. It took up core elements of the BRG, but expanded protection significantly compared to the pre-war level. As opposed to BRG and
AOG, the KSchG is not clearly based on the freedom to dismiss anymore. Rather, dismissals are valid as an exception only, while, by principle, it is acknowledged that the worker has a right on keeping his job. Only dismissals based on special reasons are socially justified (i.e. those related to the person or conduct of the employee or to urgent business requirements). Especially in the case of urgent business reasons the KSchG goes beyond the BRG, as the employer has to consider far-reaching organizational measures to avoid dismissal (Hueck, 1954, p. 57). In addition, with social selection criteria a mechanism to substantially constrain the right to dismiss is introduced. The possibility for the employer to choose between compensation and re-employment is not completely abolished, but significantly narrowed as he has to proof that there are compelling reasons that render continuation of employment impossible. Practically, opting for compensation is complicated by the fact that the employer does not know anymore in advance what level severance pay will amount to (Nikisch, 1951). Also, with a maximum of one annual wage, severance pay in the KSchG is significantly higher than in the BRG. Further important innovations are the individual right to object the dismissal and a lower size threshold of five workers. Altogether, it appears safe to say that the KSchG significantly enhanced the protective function of German labor law.

Its introduction is followed by a long period of institutional stability, lasting – notwithstanding smaller corrections – up to today. Major reform only concerned marginal elements of employment protection, namely the regulation of temporary employment. The most important step in this respect was the Employment Promotion Act of 1985 (Beschäftigungsförderungsgesetz), which allowed for the first time the use of fixed-term contracts without valid reasons (up to 18 months) and increased the maximum duration of agency workers’ assignments to six months.

5. Explaining the Trajectory of Change

As elaborated, two conflicting explanations for the evolution of dismissal protection exist: the relative strength of labor at certain points in time and the preferences of employers against the backdrop of institutional complementarities. Both can be tested at different stages of the institutional trajectory.

5.1 Interwar Period and BRG

In the German Kaiserreich preceding WWI, dominant elites (including employer associations) had an antagonistic relationship with unions. The authoritarian constitution did not allow for an adequate political participation of the growing group of wage laborers and their organizations were exposed to discrimination and repression. Backed by the conservative state, employers clearly dominated industrial relations and aggressively contained activities of organized labor. Obviously, the degree of confrontation differed. While the heavy industry and large landowners rejected cooperation, the ‘new industries’ with their highly trained and therefore more powerful workforce had to be more open-minded (Feldman, 1984, p. 102; Herrigel, 1996). Nonetheless, possibilities to achieve progress in social policy or labor law were strongly restricted for unions (Saul, 1974). The war and the following collapse of the Kaiserreich essentially changed this balance of power.

In the course of war the regime had to maintain its defense production under increasingly difficult conditions, especially a severe shortage of labor. This put unions in an extremely
powerful position. In 1916 the state was forced to intervene in the labor market in order to concentrate employment in arms production (Hilfsdienstgesetz). For this purpose labor market participation was made compulsory for men from 17 to 60 years and change of jobs was prohibited in ‘war-relevant’ industries. As circumstances allowed unions and social democrats to veto the act (the authorities could not afford to risk a labor dispute), they were able to push through major concessions: the acceptance of unions as representatives of the workforce as well as the creation of worker and arbitration committees in enterprises producing important goods for the war. With the fulfillment of these old demands, the act of 1916 can be seen as milestone for unions, with a lasting influence beyond its immediate impact on the wartime labor market. (Ambrosius, 2005, p. 301; Bieber, 1981, chapter 9).

In the revolutionary period after the collapse of the empire the window of opportunity for social policy progress was opened even wider. In fear of radical socialist forces pursuing the abolition of market-economy, employers teamed up with moderate unions in a corporatist agreement (Stinnes-Legien-Abkommen). At first, cooperation was fostered by the desire to escape state interventionism, which had grown in the war and which was expected to increase during demobilization. But the actual character of the agreement was strongly influenced by the threat of a revolution and employers’ fears of loosing their property (Feldman, 1984, p. 123). In a bipartite body, the so called ‘Central Work Association’ (Zentralarbeitsgemeinschaft), unions could take advantage of the weakened employer position and expand the achievements made in the war. Their influence even increased when the new democratic system brought a Social Democratic government into office in 1919, allowing for a whole series of changes in the field of social policy and industrial relations (Bieber, 1998, p. 51). Among the achievements of this short period were the eight-hour working day and the willingness to negotiate collective agreements. Thus, the war and the following period fundamentally changed the power balance between employers and unions – at least temporarily. Two further facts illustrate the unions’ rapidly grown influence in the early Weimar Republic. Between 1913 and 1919 the number of union members grew from below three to more than eight and a half million (Schneider, 1989, p. 494). In addition the collective bargaining coverage was ten times higher in the 1920s compared to 1914 and labor’s share in national income rose from 45 to roughly 60 percent (Abelshauser, 1987, p.25). In the course of the decade, the situation rapidly turned to the negative for unions and prior achievements were revoked. But the negotiations on the BRG still fall into the relatively short period of tumbling employer strength.

How did the employers react to the proposed BRG under these conditions? The negotiations once more revealed that their willingness to cooperate did only reflect a defensive strategy to avoid revolutionary tendencies. In fact, employers largely upheld an anti-union attitude and did everything within the realm of possibility to lobby against the BRG. The general opposition also applied to the proposed influence of works councils on personnel policies (Wolff-Rohé, 2001, p. 134). Concerning dismissal protection, the employer side insisted on a liberal design of the act. The (by present standards very modest) restrictions were perceived as unacceptable interventions in their discretionary power. For example, they opposed plans to include social selection criteria like tenure, arguing that such regulations would hamper productive potentials (Hueck, 1954). The peak association of the German industry (Reichsverband der Deutschen Industrie, RDI)
organized protest meetings in which the emphatic refusal is documented (RDI 1919; 1920). The RDI unanimously adopted a resolution stating:

“Above all, the prospective influence of works councils on the management, its right of codetermination in hiring and dismissals (...) is so dangerous for the management, order, and performance of establishments and thereby so devastating for the entire German economic life that the proposal must under no circumstance become law.” (RDI 1919, p. 17)

However, due to the political constellation, the implementation could not be prevented (despite far-reaching attempts of the RDI to influence parliamentary decision making, see Wolff-Rohé 2001, p. 136-139).

It must not be neglected that industrial employers were very heterogeneous in their interests and that decision making within the RDI was characterized by sectoral as well as geographical cleavages. But at the time, skill-intensive industries (e.g. producers of machinery, chemicals and electronics) were quite influential already and played a decisive role in the peak association³ (Feldman, 1984, p. 127). This suggests that those manufacturers who according to the VOC literature should be mostly affected by labor market complementarities were not supportive of dismissal protection.

To fully appreciate the impact of WWI on German labor law, one has to take into consideration that some hallmarks of the system directly go back to war-related state interventions. After 1918, the challenge arose to integrate soldiers, refugees, and workers from arms production into the peacetime labor market. Against the background of imminent mass unemployment and scarcity of basic goods, interventions appeared necessary in order to avoid a social disaster and political destabilization (Ambrosius, 2005, p. 310). In the field of labor law the Demobilization Act of 1920 (Demobilmachungsverordnung) contributed to tackling this problem. Two of its elements are particularly interesting. First, the principle of last resort stipulated that dismissals are only justified if a working-time reduction is infeasible. Second, the idea of social selection was introduced, so that age, tenure, and family situation had to be considered when deciding on which employees to dismiss. Although employers could successfully lobby against plans to make these achievements permanent (Hueck, 1954, p. 14), they had a lasting influence on the further legal development. For instance, social selection criteria were considered in the jurisprudence of the Weimar Republic and eventually taken up in the KSchG of 1951 (Göller, 1974, p. 54-62).

The bottom line is that WWI served as a driving force for social policy expansion and for the development of labor law in particular. Virtually all innovations of the Weimar Republic can in some way be traced back to the war and its consequences (Abelshauser, 1987, p. 15), be it in the form of authoritative interventions or via its impact on the power distribution between the social partners. The BRG was negotiated in a relatively short period in which exceptional factors shifted the balance of power in favor of unions. Thus, one can consider the original compromise on dismissal protection being biased by the asymmetric conditions of its formation.

Given the opposition of the German industry to the BRG, historical evidence seems to lend support to the conflict-oriented perspective – at least for this early stage of the

³ These industries were almost exclusively represented in the RDI’s governing body by large manufacturers such as Siemens, Bosch and Carl Zeiss. Interests of small and medium sized firms are to a lesser extent reflected in the RDI positions (Wolff-Rohé, 2001, p. 68-69).
institutional development. What does this result mean for the notion that complementarities surrounding skill formation are the crucial explanatory variable? First of all, the temporal order of the German development casts doubt on the argument. An industrial pattern of quality production emerged already in the 19th century (Abelshauser, 2003). The so called ‘new industries’ heavily relied on knowledge as a productive factor. To satisfy their demand for skilled workers many large companies employed segmentalist strategies, including in-house training and firm-based social policy to ensure loyalty (Adelmann, 1979). Hence, the production model worked for a long time without dismissal protection and it is therefore more than plausible that the German industry was reluctant to implement it in 1920. However, it is important to note that in the Weimar Republic the topic of skill creation became more pressing in some industries. Due to an intensification of international competition (especially from the United States) and the limited price-competitiveness of German production, many manufacturers were forced to go ‘up market’ in order to maintain their export shares. This demanded an ever stronger focus on quality-competitiveness. Moreover, the artisanal sector that traditionally trained workers for the industry became less and less capable of satisfying the grown demand for skills, both, in terms of quantity and quality (Herrigel, 1996; Thelen, 2004, chapter 2). It is therefore conceivable that this development did make employers embrace dismissal protection as a means to attract more specific skill investments from workers. As Thelen (2004) points out, in this period some skill-oriented industries did aspire mechanisms to strengthen engagement in training. However, this mainly meant certification rights or standardization and not employment protection. In addition, a major concern was to create a framework that reduced disincentives for employers (e.g. poaching) rather than for workers. As illustrated by the significant lack of apprenticeship places in the entire Weimar period (Gladen, 1979), attracting trainees willing to invest in skills was not the greatest issue. Accordingly, institutions were needed that could strengthen employers’ engagement in training, i.e. collective bargaining (Thelen, 2004, p. 70). Against the background of these labor market conditions, dismissal protection could contribute little to an intensification of training.

To sum up, German employers in the interwar period did not support dismissal protection and, in fact, there was little reason to do so. The question whether this attitude changed later on will be addressed in the following sub-section.

5.2 Post-WWII Years and the Dismissal Protection Act

At first sight, the process of labor law innovation after WWII differs essentially from the implementation of the BRG. In fact, the KSchG serves as a prime example of corporatist social policy making as it goes back to an agreement between employers and unions (the so called ‘Hattenheimer Gespräche’ in early 1950)\(^4\). In the following year, the draft passed the Bundestag with minor changes. Thus, the KSchG reform lacked the extremely

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\(^4\) Up to 1950, employers re-organized themselves in the Bundesvereinigung der Deutschen Arbeitgeberverbände (BDA), an encompassing peak organization, and the Bundesverband der Deutschen Industrie (BDI), which represented interest of the industry. While the conservative BDI clearly was the dominant group in the post-war years, the comparatively progressive BDA was responsible for negotiating with unions in the field of social policy. Since it was the unions’ negotiating partner in Hattenheim, I will focus in this section on the role of the BDA. However, as the BDI could exert strong influence on the positions of the BDA, its interests were reflected in the negotiations (Berghahn, 1985, p. 64-67, 202-220).
conflict-laden character of the BRG introduction in 1920 and proceeded, by any standards, more consensual. This leaves, however, the question open whether employers turned from veto players into proponents of dismissal protection or whether they consented out of strategic reasons. To answer this question, the historical context needs to be considered.

After the war, there was a very unsatisfactory regulatory situation for employers, which strongly increased pressure to enter into negotiations with unions about dismissal protection. Dismissals required a pre-emptive check by the public employment office, which – at least in the perception of employers - favored labor market policy concerns over firm interests (Zentralsekretariat der Arbeitgeber des vereinigten Wirtschaftsgebietes, 1948b, p. 3-6). The increased importance of courts, whose decisions tended to be rather restrictive on dismissals, created legal uncertainty. In some of the Länder of the French and American zones, new laws with very rigid provisions were implemented (Hueck, 1954, p. 18; Nikisch, 1951). As a consequence of the chaotic post-war situation, employers faced strong short-term incentives to reach a homogeneous and predictable legal basis for dismissals, which in principle would allow for the free allocation of labor.

To understand the employers’ willingness to cooperate in the formulation of a draft, the alternative conceptions for dismissal protection of that time should be considered. After 1945, unions were quickly able to organize themselves and to regain their capacity to act. The common experience of emigration, resistance, and terror helped to overcome the old fragmentation of the union movement (Rosenberg, 1948). By the allies, unions were considered from the start as legitimate forces in the democratic reconstruction, while political parties as well as encompassing employer associations were seen skeptical (Mielke, 1990; Barthel, 1999). Thus, after the war and particularly after the foundation of a unified peak organization (Deutscher Gewerkschaftsbund, DGB) in 1949 the unions had a quite powerful position. By 1948 union density already amounted to 42% in the British occupation area (38% and 30% in the American and French, respectively, Schneider 1989, p. 241). This is reflected in an aggressive anti-capitalist agenda. Radicalized by the experiences of the war, the DGB took up an antagonistic position towards the conservative employer associations, especially in the field of codetermination. Further demands were stronger redistribution, elements of central planning and socialization of key industries (DGB, 1950, p. 318-326).

This anti-capitalist attitude was shared by the two biggest political parties, the Social Democrats (SPD) and – at least in its early years – the Christian Democratic CDU. Concerning labor law, union plans aimed at the complete abolition of the freedom to dismiss. The employment relationship should effectively not be terminable and, therewith, lose its contractual character. A similar conception could be found in the draft of the Economic Council (see section 4) and both major political parties supported strict regulation of dismissals. In its 1949 program the CDU demanded enhanced protection with dismissals as exceptional cases only, while the SPD still favored the idea of a centrally planned economy (Richardi, 2001, p. 169).

Hence, a broad political consensus supported a tightening of dismissal protection compared to the pre-war era. Employers had to consider the prevalent market skepticism when negotiating basic organizational principles of the new economic system. Legitimizing the new order and thereby ensuring support and stability was an important
element of the employer lobbying strategy of that time. Radical demands were considered neither feasible nor appropriate.

This notwithstanding, evidence suggests that employers maintained their preference for flexible regulation. They firmly rejected the plans aiming at quasi lifetime employment and insisted on their right to choose between compensation and re-employment (Siebrecht, 1951). The BDA, which conducted negotiations with unions about dismissal protection, took up the position that it was of utmost interest to defend the conception of the employment relationship as a “voluntary and terminable contract” (Sozialpolitische Arbeitsgemeinschaft der Arbeitgeber, 1949b; 1949c). An initial employer draft of 1948 was still strongly oriented towards the rudimentary design of the BRG, especially in the reasons for justified dismissals (Zentralsekretariat der Arbeitgeber des vereinigten Wirtschaftsgebietes, 1948a, §1). Concerning severance pay, they demanded to go back to the low level of the BRG and objected plans to increase it (§7; Sozialpolitische Arbeitsgemeinschaft der Arbeitgeber, 1949a). Further contentious points were the size threshold of firms and the probationary period. After “long and tough negotiations”, the agreement of Hattenheim was seen as a compromise, which in many ways went beyond the initial employer position (Vereinigung der Arbeitgeberverbände, 1950, p. 5). But as it successfully upheld the basic principles of private law and contractual freedom, the prime demand of the employer camp, it was considered “acceptable for business” (ibid., p.8).

One can summarize the position of employers in the post-war period as follows: by principle, dismissal protection should be as flexible as possible. Again, there is no evidence suggesting that employers did shape their preferences according to the institutional complementarities assumed by the VOC approach. The Hattenheim agreement was perceived as a far-reaching concession that was unavoidable given the political constellation. Yet, it was preferred over, first, an extremely unsatisfying status-quo and, second, ambitious union plans (which had some political support and realistic chances to be implemented).

5.3 Rise and Fall of a Golden Age

It can be argued that many institutions of the German employment model reflect the exceptional character of the post-war economy, i.e. catch-up growth and skill shortage (Pierenkemper, 2009). While this might be true for other areas of social policy, the mutual consent on dismissal protection was not favored by the economic context. Between 1948 and 1951 the German economy went through a crisis so that at the time of the Hattenheim negotiations unemployment amounted to 12.2 percent (Abelshauser, 1987, p. 78). As long as migration from the GDR (and formerly German areas in Poland and Czechoslovakia) contributed to labor supply, manpower shortage was not much of a problem in West Germany (Eichengreen, 2008). The KSchG therefore should not be attributed to favorable economic circumstances but to political factors presented above. However, the boom of the 1950s and 60s surely helped to stabilize the new institution. In a context of high growth, full employment, and even labor shortage dismissal protection did not produce any adverse effects for the German economy. But obviously, these circumstances were temporary. Germany’s ‘economic miracle’ benefited from two factors related to the war and both implied return to normality - if not to sluggish growth. First, mechanisms of catch-up and convergence drove economic recovery. Of course, rebuilding the capital stock and closing the productivity gap to the US by adopting new
technological or organizational knowledge were soon exhausted as sources of growth. While this applied to all European economies the German post-war boom profited from a second factor. German production was specialized into goods which were required urgently for the reconstruction in other countries. The wartime economy had been heavily oriented towards products such as machinery and metals. After the war, Germany therefore had the skills and the infrastructure available to export these highly demanded capital goods (Eichengreen, 2008, chapter 3; Abelshauser, 2004, p. 48-50). This advantage vanished at the latest when growth became increasingly based on service sector expansion.

With the return of normal growth rates and business cycles, it began to matter that the institutional setting had been ‘biased’ in its creation. A 1976 survey, conducted by the Association of German Chambers of Industry and Commerce (Deutscher Industrie- und Handelstag, DIHT) for the Council of Economic Experts, indicates that employers started to perceive dismissal protection as a problem. While cautious business expectations, rationalization and wage pressure dominate as reasons, 24 percent of industrial employers said that dismissal protection was the most (or second most) important obstacle to creating new jobs (Sachverständigenrat, 1976, p. 208). This attitude was relatively strong pronounced among producers of machinery, fine mechanics and metals (DIHT, 1977a, p. 58). Accordingly, representatives of the industry started to complain about a lack of flexibility in personnel policies and employment relationships “for eternity” (DIHT, 1977b, p. 28).

Yet, for the time being this changed perception did not translate into strong reform pressure. After the golden age had cushioned the conflict between capital and labor for two decades, in the 1970s it turned out that there was little leeway left to reverse the development of dismissal protection. At the time, the institution already produced typical positive feedback effects for an important voting block. The high popularity of dismissal protection among insiders and union resistance to any liberalizing changes created strong reform barriers. Quite to the contrary, unions interpreted the rise of unemployment in the 1970s as an indicator for a lack of protection (IG Metall, 1978). In a draft labor code the DGB demanded to practically abolish the freedom to dismiss by giving works councils an effective veto right and to create obligatory severance pay (DGB, 1977, p. 177-178). In the 1970s unions were relatively influential with approximately 7.5 million members and close ties to the Social-Liberal coalition (1969-1982). Even if tensions between unions and Social Democrats increased after pragmatist Helmut Schmidt took over the office from Willy Brandt, in the middle of the decade more than half of the members of the Bundestag were also DGB members (von Beyme, 1990, p. 368).

Although employers still preferred a flexible design of dismissal protection, this political situation did not leave any scope for deregulation. The BDA fought the union draft and campaigned for the principle of ‘freedom of contract’ in the employment relationship (BDA, 1978; Kittner, 1988, p. 755). But rather than promoting liberal reforms, employers were again in a defensive position to avoid further tightening of regulation. Against this background, it is not surprising that flexibilization started with a very typical but often neglected mechanism: defection from the institution on the micro-level by creatively ‘working around’ it. Already in the 1960s employers started to increase external flexibility by supplementing their core workforce with a marginal tier of agency workers, who could be used to handle production peaks. This option, initially offered by
Swiss agencies, was deemed illegal for violating the state’s placement monopoly, but eventually legalized by the Federal Constitutional Court in 1967 (Mayer, 1986). The following boom of agency work, especially in construction and the metal industry, led to protests by unions, which considered this practice “slave trade”. In 1972, the SPD-led coalition decided to regulate agency work in order to restrict defection from standard employment.

5.4 The Employment Promotion Act
Opportunities for deregulation increased with the change of government in 1982. Against the background of structural unemployment, the new centre-right coalition was more receptive to calls for increased flexibility. After employers had been on the defensive in the late 1970s, they now pressed their claim. Under the heading “more market – less state” the BDI explicitly demanded to ease dismissal law (BDI, 1984, p. 24-25).

In line with these demands and with an international trend towards supply-side orientation, deregulation of hiring barriers appeared on the political agenda (Schmid and Oschmiansky, 2005). The first tangible result of this paradigm change was the Employment Promotion Act of 1985 (section 4). BDI and BDA took a clear stance in the reform discussion. They very much appreciated the flexibilization of temporary contracts, which had been suggested by them before. Also, employers successfully influenced the legislative process. Their demands to increase maximum duration to 18 months and to allow fixed-term contracts for all newly hired employees (BDA, 1985a, p.11) were implemented. The Act was, however, only seen as “one step in the right direction” which should be accompanied by more far-reaching measures, including the ease of redundancies (BDA, 1985a, p. XIII; 1985b, p.29; BDI, 1988, p.72).

This more ambitious reform agenda failed due to contradictory forces in the governing coalition. While the liberal FDP supported employer demands, left-wingers in the CDU rejected further deregulation. The Employment Promotion Act already led to heavy protests by SPD and unions against undermining of dismissal protection (Schmid and Oschmiansky, 2005). After losses in the 1987 elections were interpreted as a punishment for too far-reaching social cutbacks, the window of opportunity for further reforms was closed.

Hence, the (by international standards modest) liberal turn of the 1985 Act also illustrates the limits of the politically feasible extend of deregulation at that time. Yet, legal change was consequential. Between 1984 and 1986 the share of fixed-term contracts in total employment rose from four to more than eight percent (Schmid and Oschmiansky, 2005, p. 251). Beyond this immediate effect, the Employment Promotion Act can be seen as a starting point of further incremental change. The following two decades witnessed a successive liberalization of temporary contracts and a constantly growing share of workers in this segment. This development serves as an illustrative example for the mechanism of layering which over time produced the very flexible arrangements of today (Eichhorst and Marx, 2009).

6. Conclusion
Dismissal protection in Germany has been largely shaped in two ‘critical junctures’. In both cases, exceptional conditions hampered the ability of employers to resist demands for stronger protection (which would have corresponded to their actual preferences).
Hence, the formative compromise was ‘biased’ in favor of employee interests. In the 1950s and 60s this did not matter too much. Due to two ‘golden’ decades, it was only in the 1970s and 80s that the rigidity of dismissal protection was perceived as hampering economic restructuring. Then it became apparent that the post-war compromise was, with hindsight, not designed to serve the needs of a ‘normal’ economy – at least from an employer point of view. After Germany returned to modest economic growth rates, the institution was ‘locked-in’ and employers had to live with a level of protection they probably would not have consented under less critical circumstances.

By no means should the results be read in such a way that unions dominated industrial relations for the past 90 years. Quite to the contrary, in the course of the 1920s as well as in the more recent history, unions struggled with significant losses of influence. The crucial observation rather is that the relatively short periods of labor strength around formative compromises had a lasting influence. This is in line with the mainstream path dependency argument that it is easier to expand the welfare state than to cut it back (Starke, 2006).

Summing up, the trajectory of change described in this paper was determined by the combined effect of four factors: 1) the impact of contingent events (i.e. wars) on the power resources of relevant actors, 2) the bias this created for the formative compromise on dismissal protection, 3) the path dependence of the resulting institution and 4) changed circumstances which made the ‘losers’ of the initial negotiation (i.e. employers) challenge the institutional arrangement.

What do the results mean for the two theoretical questions raised in the beginning (endogenous vs. exogenous change and conflict-oriented vs. functionalist explanation of employer preferences)?

Following the above interpretation, flexibilization at the margin of the labor market, which started in the 1980s and continues up to today, cannot be ascribed to exogenous factors only. Deindustrialization and international competition certainly contributed to the development by decreasing demand for some types of jobs. By increasing cost pressure, they probably even have been necessary to push employers over the “critical threshold point” (Mahoney, 2000, p. 523) to challenge dismissal protection. But change was endogenous in so far as ‘loser’ of the initial negotiations started to undermine the status-quo. The institution therefore rested upon a fragile and, with hindsight, unsustainable compromise. The agreement of Hattenheim ‘froze-in’ an asymmetric settlement to a fundamental conflict. And as the conditions under which the initial settlement came into being were transitory ones, the intrinsic conflict (shelter from market fluctuation vs. need for adaptability) made the institution inherently unstable. This was, however, contrasted with strong path dependence. As reform of dismissal protection did not appear feasible, employers adapted their production as well as their lobbying strategies to marginal types of flexibility.

What should be taken from the analysis is that the reasons for change potentially can already be found in the conditions under which an institution emerged. This leads to a different evaluation of change in the political economy: liberalization did not suddenly crowd-out a consensual Garden of Eden as the consequence of ‘globalization’ or ‘neo-liberal’ ideology. In an extended analytical perspective, it appears as the continuation of a conflict which has been there throughout the existence of the institution. I tend to believe that this insight goes beyond the case of German labor law and applies to various
contentious institutions in the political economy (see Koreh and Shalev, 2009 for a similar argument).

This would imply that the common practice of analyzing the decay of institutions only is very often not sufficient to fully understand the reasons for change. Rather, the interactions between endogenous and exogenous factors should receive more attention. As I argue in this paper, the former can be accounted for, if the formative phase of an institutional arrangement is included in the analysis.

Concerning the second question addressed in this article, the historical analysis suggests that at no time employers preferred strict over flexible dismissal protection. This is not to deny that the German production model in manufacturing is particular compatible with marginal flexibility (as a stable core workforce with specific human capital can be combined with a flexible, low to medium qualified segment). And in a comparative perspective, dismissal protection certainly is less adverse in a specific skill regime with mutual interest in long-term employment relationships than in a liberal economy with a dynamic labor market. Yet, it appears that the VOC approach vastly overemphasizes its functional importance for rational human capital investments.

How can the discrepancy between the functionalist reasoning and the results of this paper be explained? In a recent critique, Busemeyer (2009) argues that the VOC logic neglects the real portability of qualifications. In Germany, certification of skills ensures a high transferability, at least within an industry. And traditionally, vocational training provides polyvalent skills which are by no means applicable to one firm only. Hence, the question is not which incentives exist for workers’ investment, but why firms bear potentially sunk costs of training. Since factual transferability makes employers vulnerable and not workers, the transaction cost problem cannot be solved by dismissal protection, but only by mechanisms preventing poaching. In addition skill specificity (which the employer also depends on) implies a limited ability to replace workers and therefore serves as an implicit protection in itself (Emmenegger, 2009).

With the VOC argument revisited in this way, complementarities between skill formation and dismissal protection provide no plausible reason for German employers to support strict regulation (which is in line with my results). Since Germany is usually considered a crucial case in the political economy literature, this has implications for the theory: one should be more careful in theorizing about the effect of dismissal protection and other institutions on production models. Anyway, more empirical accuracy is needed to establish such complementarities. Historical analyses can make a substantive contribution to this process.
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