German Welfare Capitalism: Crisis and Transition

By Roland Czada

Not long ago, German welfare capitalism was declared ailing or even dead (Manow/Seils 2000). Since 2006, however, the "sick man of Europe" of the 1990s has shown new signs of vitality. Exports grew from 24 percent of GDP in 1991 up to 39.8 percent in 2006. Public deficits and unemployment rates are declining now. How does one explain this turn? Is it just globalization that drives German exports or are certain favorable conditions of the German political economy still alive? Did the center-leftist Schröder-Fischer government's Agenda 2010 save the country or is there another cause that has to be explored in order to understand what happened?

Extensive reforms of the welfare state notwithstanding, parts of the German variety of capitalism are still effective. The traditional dominance of manufacturing and mechanical engineering has proved beneficial in times of expanding global markets. Despite their tremendous growth prospects, these industries have been less bubble-prone than financial and asset businesses. Additionally, when it comes to explaining persistent surpluses in exports, labor relations and social security schemes, though modernized, appear to still be important.

Germany in the Global Economy

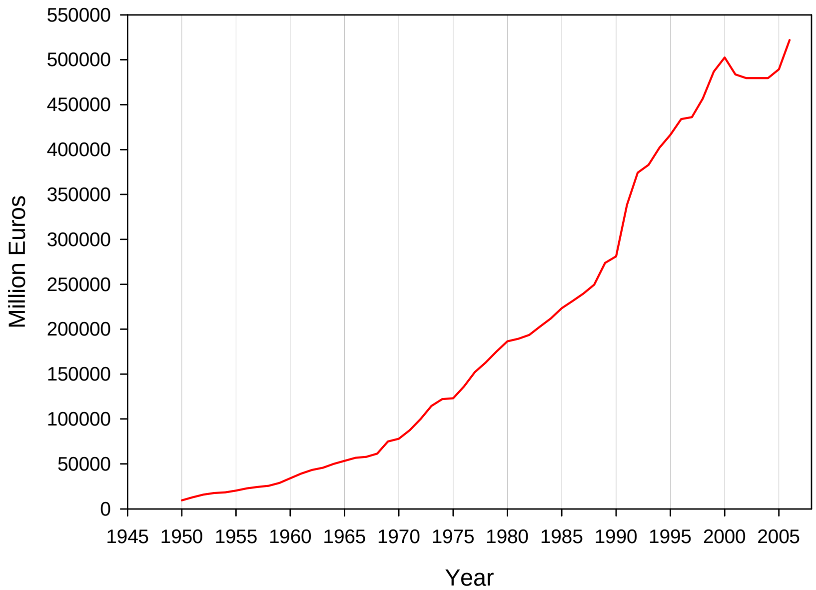
Given its high level of exports of about 40 percent of GDP, Germany is said to be much more affected by economic globalization than, say, the United States or Japan; however, one has to keep in mind two-thirds of German exports remain within the European common market. Germany's exposure to foreign markets has been countered by European integration and even more by the Euro-zone. As a consequence the country is less sensitive to global economic turbulence and, thus, less vulnerable today than ever before in its economic history.

Adding its export share within the EU to those going to emerging markets like China, Russia, India, the Middle East, and South Africa, the German economy has certainly gained some independence from the U.S. economy. It is now less bound to the U.S. market than, say, Japan or China. Of course, this varies across sectors and products. Car manufacturers, for instance, still heavily depend on U.S. sales.

Despite the EU serving as a major buffer against the imponderables of global trade, Europeanization restricts national policymaking to react adequately on economic and social challenges on the domestic level (Scharpf 2003). EU membership deprived national governments of policy instruments like tariffs, deficit spending, currency- and exchange rate manipulations, and even taxation and welfare spending. Tax cuts proved inevitable to attract foreign investments and also to keep mobile production factors at home. Besides tax competition within the EU, low wages and welfare state differentials in the new eastern member states—as well as reunification costs—put pressures on the German welfare system. In particular, *German tax revenues* declined sharply after several tax cuts while public welfare spending continued to explode at the turn of the millennium (figure 1).

This essay appeared in the August 8, 2008, AICGS Advisor. http://www.aicgs.org

Figure 1: Nominal Tax Revenues 1950 - 2006 (General Government)



Source: Statistisches Bundesamt, *Kassenmäßige Steuereinnahmen Deutschland 1950 bis 2006* (21 July 2008).

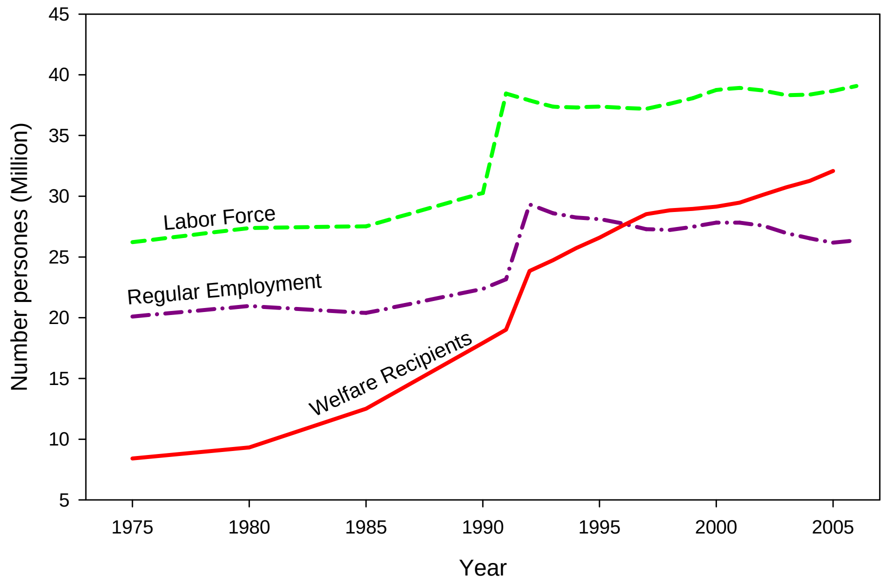
Nominal tax revenues slumped dramatically in 2000—for the first time since the founding of the Federal Republic. Many have speculated why the Schröder government enacted its massive welfare state reform policies in 2000. The center-leftist government's welfare retrenchment policies undermined its earlier intentions to preserve the welfare state, risking losing massive votes in federal and state elections to come. To explain Agenda 2010 by ideology—a neo-liberal orientation—obscures the fact that the government was mainly led by situational constraint and a strong feeling of practical necessity to close the *revenue-outlay gap*.

Causes of the Welfare Crisis

Two distinct factors contributed to the ever widening revenue-outlay gap and, thus, made up the context of policy challenges to the German welfare state. The first factor can be traced back to the so-called "German Model" of forced industrial *modernization policies*; the second stems from the *unification* of the economically weak socialist German Democratic Republic with the still prosperous Federal Republic of Germany.

From the late 1970s onward, German governments have prioritized industrial modernization policies to preserve high wages and welfare standards on the basis of high industrial productivity. The concept culminated in the model of a "blueprint-nation," an industrial knowledge economy combining skilled labor with high-tech manufacturing. Resulting job losses, as well as the vanishing of industrial sectors with low-productivity and low-income, were meant to be compensated by social welfare policies. A number of social scientists at the time hailed the *corporatist productivity coalition* between the national government, labor unions, and employers associations. The conservative Kohl government put the concept into action through a massive early retirement program in 1984. Overall, rejuvenating the workforce proved to be successful at first. Nominal unemployment rates dropped slightly during the 1980s and in 1999 more than a third of the new pensioners retired due to unemployability at an average age of 52.

Figure 2: Labor Force, Regular Employment and Welfare recipients (1975 - 2006)



Notes: Welfare recipients include old age pensioners, recipients of unemployment benefits, recipients of accident annuities, general welfare recipients, and asylum seekers. Regular Employment: Number of wage earners paying compulsory social insurance fees
Source: Bundesministerium für Arbeit und Soziales, 2007: *Statistisches Taschenbuch 2007.Arbeits- und Sozialstatistik*. Berlin: BMAS, Statistisches Bundesamt.

The "Model Germany" approach resulted in disproportionately rising numbers of welfare recipients and, as a further consequence, rising non-wage labor costs. As Figure 2 shows, this was also an effect of the so-called "unification shock," which in 1990 saw Germany's GDP per capita drop by DM 6,000 (€3,077) to DM 34,990 (€17,943) as a result of the number of inhabitants growing faster than economic output. Additionally, while the new constitutional states in eastern Germany experienced massive job losses in the aftermath of a historically unique de-industrialization process, the western German economy, which remained strong, had to shoulder the resulting social costs. Accordingly, the social expenditure ratio (i.e., public-welfare expenditure as a share of GDP) rose sharply after unification (Figure 3). Thus, unification policies followed the industrial modernization track that had previously been put to a test in West Germany.

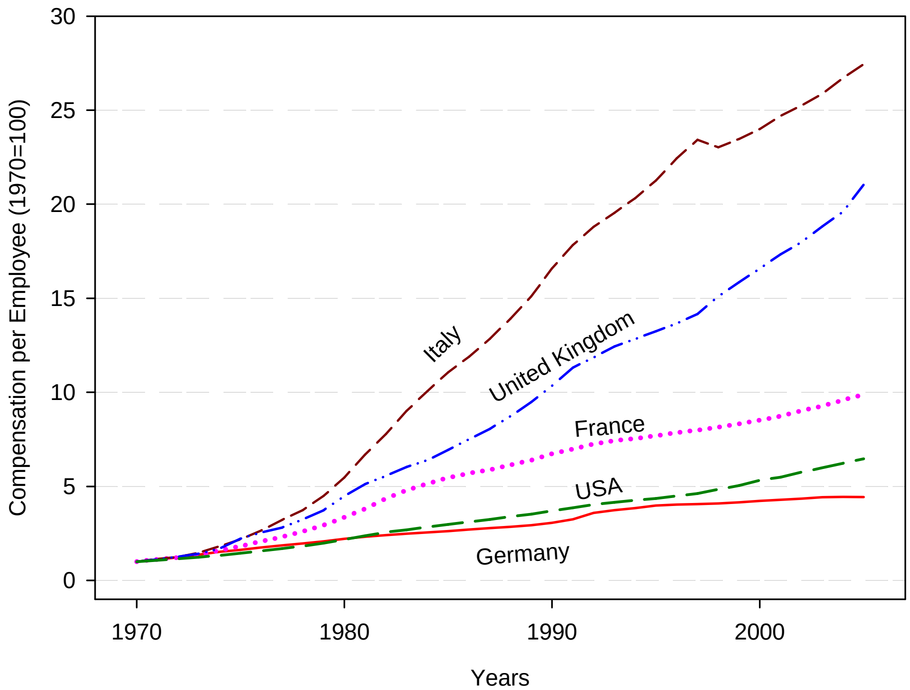
The Cure

Looking back, one has to concede a partial failure of the Model Germany approach or "blueprint nation" concept at least. To be sure, when it comes to productivity German industry is still on top. The share of high-tech and medium-high tech in manufacturing is highest compared to all other OECD-countries (Kaloudis / Smith 2005). Simultaneously, overall economic growth rates have been lowest and early retirement as well as unemployment rates have risen from the early 1990s until 2005. In other countries, however, medium and low-tech industries pushed growth rates and employment more than the German-style forced industrial modernization policies (Kaloudis / Smith 2005). The latter not only overstressed but also eroded the German welfare state. Exploding non-wage labor costs, high unemployment, and a rising ratio of the working poor have to be seen as delayed consequences of the "blueprint-nation" concept.

Despite the fact that some low-productivity sectors—like coal or mass steel products—diminished, the German economy is still heavily biased towards manufacturing, e.g., of cars, trucks, plant engineering, construction, chemicals, etc. The global economic conditions have been favorable for exactly that kind of specialization. Thus, the early focus on industrial modernization instead of on sectoral restructuring may have stood the test of time. Germany's unions and leftist politicians, however, argue that economic recovery stems mainly from a long period of wage restraint. Indeed: for the majority of the population, real wages in Germany have been sinking over the recent past. In 2006, they fell to a level last seen twenty years ago. According to figures from the Labor Ministry, adjusted for inflation, a German worker received on average €15,785 Euros last year after taxes and social insurance contributions. This equates to net earnings of only €1,320 a month, only five Euros more than in 1986. Among other causes, unification has disciplined the work force more than cooperative unionism this time.

Inequality within the lower wage categories in the 1990s increased significantly after German unification. In other words, the reunification of Germany and the low wages in the east were used to ratchet down wages in the west, and in particular in the lower income levels. As a result, unlike some years ago, highly qualified Polish workers no longer seek work in Germany. They can enjoy better conditions in Norway, Spain, Italy, and particularly in Britain and Ireland than in Germany.

Figure 3: Compensation per Employee (1970=100)



Source: Compensation of Employees per Employee, Total Economy - EU-KLEMS Database

Since the introduction of the Agenda 2010 reforms, unemployment has declined and the range of low-wage jobs expanded. Since 2002, coinciding with the implementation of the Hartz welfare reforms, the ratio of part-time employees to the overall workforce has risen from approximately 11 to 17 percent. Moreover, another consequence of the Hartz reforms was the massive increase in so-called marginal jobs from three to now six million people.

The Agenda 2010 welfare retrenchment program succeeded in creating jobs, particularly in low-income brackets. Among its politically unpleasant consequences one finds an increased number of disappointed voters. Some of them—the unemployed and low-income-earners in particular—account for the steep rise of the new socialist party *Die Linke*. At the same time, middle-income earners have pressed the federal government to take back parts of the welfare retrenchment program of its predecessor namely to re-introduce some tax privileges. Coming federal elections in 2009 as well as elections in Bavaria this year and in Thuringia, Brandenburg, Saarland, and Saxony next year will tempt the Christian Democrats in particular to demonstrate social conscience. Otherwise, as Chancellor Angela Merkel's party fears, the Social Democrats and *Die Linke* would take office next year. Despite the electorate drifting to the left, a majority of politicians will still engage in preventing a left-based government.

Bibliography

Czada, Roland, *The End of a Model? Crisis and Transformation of the German Welfare State*. WP 1/04 University of Osnabrück: Social Science Department http://www.politik.uni-osnabrueck.de/wp/WP%201_04%20Czada.pdf

Kaloudis, Aris / Smith Keith, 2005: *Structural Change, Growth and Innovation: the Roles of Medium and Low Tech Industries, 1980-2002*. Contribution to the conference Low-Tech as Misnomer: The Role of Non-Research-Intensive Industries in the Knowledge Economy Brussels.29/30 June, 2005.

Manow, Philip/Eric Seils, 2000: *Adjusting Badly: The German Welfare State, Structural Change, and the Open Economy*. In: Fritz W. Scharpf/Vivien A. Schmidt (eds.), *Welfare and Work in the Open Economy*, Vol. II: *Diverse Responses to Common Challenges*. Oxford: Oxford University Press.

Scharpf, Fritz, W., 2003: *Regieren im europäischen Mehrebenensystem - Ansätze zu einer Theorie*. In: Leviathan 30 (1).

This essay is the result of an AICGS conference on "German Vulnerabilities in a Globalizing World," which was held in March 2008 with the generous support of the National Intelligence Council, the University of Birmingham, Deutsche Lufthansa AG, and the International Association for the Study of German Politics (IASGP).