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The stalling engine in Wirtschaftswunder-Land: Germany's economic policy challenges

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K I E L D I S C U S S I O N P A P E R S

**The Stalling Engine in *Wirtschaftswunder-Land*:
Germany's Economic Policy Challenges**

by Horst Siebert

An Englishman once watched his first American football game. He looked intently as the team gathered into a huddle after each play. His American host asked him what he thought of the proceedings.

“Not a bad sport,” remarked the visitor, “but they do seem to engage in an excessive number of committee meetings.”

Maybe what is true for American football is much more typical for the German economy nowadays, where trade unions and employers’ associations determine the wage rate and where round tables are used to find solutions to economic policy challenges.

On the more serious side, I want to talk about some of the economic policy challenges that Germany faces. Being an optimist by nature, I would paint a rosy picture, especially when abroad. As an academic, however, I have to paint a realistic picture.

1 The Loss of Economic Dynamics

After the unification boom of the early 1990s with GDP growth rates of 5.7 and 5.0 percent in 1990 and 1991, respectively, Germany has had an extremely weak growth performance with a low growth rate of GDP of 1.6 percent per year in the period 1995–2001. This is roughly two percentage points lower than the rate of the United States. Since 1994, the German growth rate has been lower than the EU average in each year, and since 1998 Germany and Italy have alternated in being the tailender of the European Union in terms of growth. The forecasts for 2002 indicate the same story. To correct for population dynamics, for the slowing construction sector or to exclude strongly growing countries in Euroland that are catching up, like Ireland, Spain, and Portugal, does not change the story. The German engine is stalling. German growth performance is definitely a problem relative to the experience of the other industrial countries.¹

Germany’s poor growth performance is partly linked to high unemployment, with 4 million officially unemployed and 1.7 million in labor market programs of various sorts (in 2002). After all, an important economic resource, labor and human capital, is being wasted. But Germany’s growth performance also goes hand in hand with its loss of world market share in commodity exports since 1991, by 2.7 percentage points, from 11.4 to 8.7 percent in 2000 (Figure 1; Siebert 2002c); this is below the long-run average of 10.6 percent for the period 1975–1989. It can be argued that the convergence of developing countries implies a decline in the world market share of industrial nations. But, in contrast to Germany, the United States has succeeded in holding onto its world market share, and other countries have lost less. Moreover, Germany’s share in the industrial goods exports of all OECD countries is declining; this also holds relative to other industrial countries such as the United States, France, and the United Kingdom.

Manufacturing, which accounts for 23 percent of employment, produces 89 percent of Germany’s exports. Four sectors of manufacturing account for 59 percent of total exports: machine building goods (18.9 percent), cars (17.7 percent), chemical products (12.2 percent), and electro-technical products (10.3 percent, data for 1999). Germany’s exports are overproportional with respect to commodity exports and correspondingly underproportional in services.²

Machine building and car production still have a high comparative advantage³ (although German daughters of American car firms and the German mother of an American daughter are having some problems at the moment). But in the last two decades, the electro-technical industry, the production of

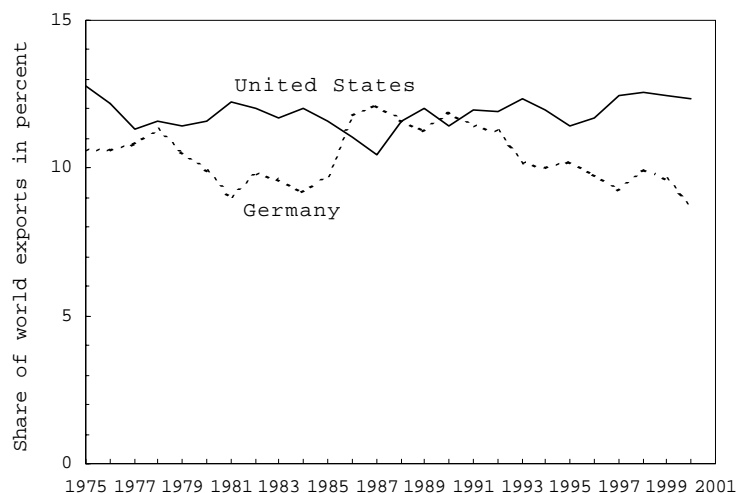
¹ Japan’s similar fate cannot be a consolation.

² For instance, the ratio of the share in world commodity exports to the share in commercial services for Germany is 1.63 (1999) whereas the ratio is below one for other OECD countries except Japan (Langhammer 1999: Table 4).

³ Measured in RCA coefficients.

telecommunications instruments, and the optical industry have lost their comparative advantage. The pharmaceutical sector seems to be eroding as well, so that Germany can no longer claim to be the pharmacy of the world economy. BASF has sold its pharmaceutical branch to Abbot Laboratories; Hoechst has ended up in the new firm Aventis. The traditional chemical sector does not seem able to participate in the technological race for the pharmaceutical products of tomorrow. New innovative IT and biotechnological products have to be imported.

Figure 1: Shares of World Commodity Exports in 1975–2000: Germany and the United States



Source: IMF, *International Financial Statistics*. CD-ROM, February 2002.

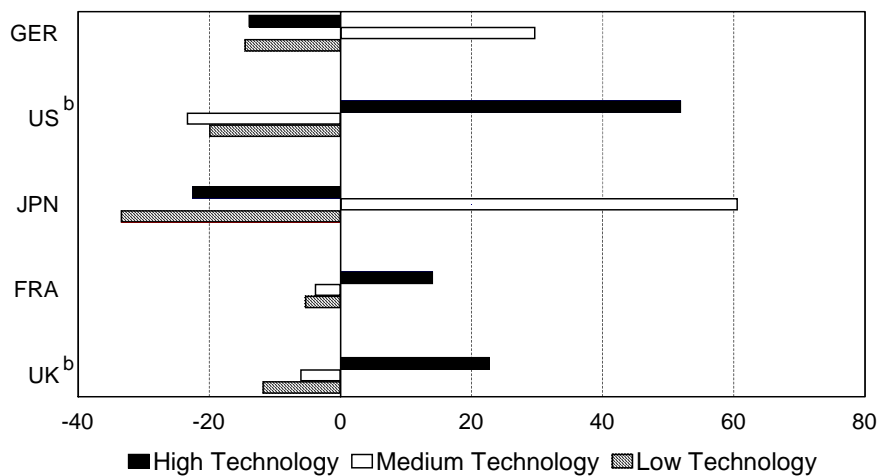
Germany is heavily specialized on medium-technology (Figure 2), where the level of technology is defined in terms of R&D expenditure relative to the product price. Especially medium-sized firms of the “*Mittelstand*” have been successful with new sophisticated and human-capital-intensive medium technology in niches of the world market. By the same token, Germany exhibits a comparative disadvantage in high-tech products relative to the United States, France, and the United Kingdom. With respect to the technology intensity of exports, Germany has a pattern of specialization which is similar Japan’s.

Export prices of commercial products only increased by 0.8 percent per year in the 1990s (it was 2 percent in the 1980s). Export unit values, the relation of prices of German commodity exports to world commodity exports (both in U.S. dollars) fell by 8 percent in the 1990s (IMF 2002). This indicates narrow scope for setting high product prices and for shifting costs.

West Germany’s manufacturing sector, which is nearly equivalent to the export sector, has lost 1.65 million jobs since 1991 (in plants with 20 employees and more). This is a sizable loss relative to the 5.7 million employees actually in that sector.⁴

⁴ Another indicator for competitiveness is foreign direct investment. A country attracting foreign capital is competitive as a location. Except for the year 2000, when Vodafone acquired Mannesmann, there was a net outflow of foreign direct investment from Germany of €26,194 per year in the 1990s (1990–1999). With respect to foreign direct investment, greenfield investment, i.e., new plants, and ownership investment have to be distinguished (Klodt 2001). Whereas greenfield investment has a direct impact on the production potential of an economy, ownership investment brings in new management, different organization, and possibly a new technology which affects production potential only indirectly.

Figure 2: Competitiveness according to Technology Intensity^a, 1999



^aRCA coefficients according to technology intensity. – ^b1998.

The three issues, low growth performance, high unemployment, and the loss of world market share are interrelated. Unemployment is a reason for low growth, and weak economic dynamics partly explain the high unemployment. The loss of competitiveness may be an underlying cause for both issues.

Let us look at the reasons for poor growth performance.

2 German Unification and the Fiscal Policy Stance

German unification represented a major change in the economic conditions of Germany. In eastern Germany, it was a major change in the lives of people. The state-owned firms had to be privatized. Production had to be oriented towards the markets of the West. A new capital stock in the business sector, in infrastructure, and in housing had to be built up.

The transformation of eastern Germany did not go as well as initially expected. Hopes that the German *Wirtschaftswunder* of the early 1950s could be replicated did not materialize. First, investment in eastern Germany was not a bottleneck problem, as in West Germany after 1945, when the repair of a single bridge over the Rhine River represented a huge productivity boost. In eastern Germany, the whole capital stock had to be redone. Second, exchanging the East German mark 1:1 to the West German Mark formed the wrong expectations, causing a devastating impact on wage negotiations. Wages were quickly out of line with productivity, and unit labor costs were much higher than in western Germany. Third, German monetary union implied an appreciation of the East German mark by some 400 percent, an unprecedented price shock in postwar history and too much for any firm, especially those inefficient ones used to central planning.

German unification required annual public transfers from the west to the east of 3–4 percent of German GDP in the 1990s, the overwhelming part not for investment but for consumption. Transfers were partly financed by new debt, leading to more than a doubling of government debt from €0.46 trillion in 1989 (or 42 percent of GDP) to €1.2 trillion in 2001 (60.5 percent of GDP).

Eastern Germany, excluding Berlin, is now at 68.5 percent of western German GDP per capita (2000). It started out at 34.6 percent in 1991. In a policy-oriented approach it does not make sense to exclude Berlin from the eastern German region. If it is included, the eastern German region is now at 72.6 percent of the western German level. Taking into account that some western German *Länder* such

as Rheinland-Pfalz, Niedersachsen, Saarland, and Schleswig-Holstein reach 80–85 percent of the western German level, this is not a bad achievement.

The manufacturing sector in eastern Germany has exhibited sizable growth rates in its net output, for instance, 7 percent in real terms in the period 1998–2000, albeit starting from a low level. In branches where new plants were built, as in car production, in the IT sector, in communications, and in aerospace, high growth rates can be observed since 1991. In the construction of railroad cars, in ship building, and in leather and textiles, the rates have been negative (Ragnitz et al. 2001: Figure on p. 5). These are partly sectors with structural decline in western Germany as well. In machine building, the new activities could not offset the decline caused by transformation.

Since 1997 the growth rate of real GDP in eastern Germany has been below the German rate. This means that the convergence process has reversed. This is partly due to a decline in the construction industry, as a correction to an over-expansion in that sector in the early 1990s due to public subsidies.

It is quite apparent that German unification and the transfers in the magnitude of 3–4 percent of GDP have affected Germany's fiscal policy stance negatively. The scope for tax reductions is severely reduced. Thus, even after the 2001 tax reform, the effective average tax rate for German corporations is still the highest in the EU.⁵ There was a real appreciation of the deutsche mark as a consequence of unification in the early 1990s, which affected Germany's competitive position until 1995. It seems that western Germany is partly inhibited by financing the transfers, but it also seems that Germany cannot unfold enough economic dynamics for a strong carryover to eastern Germany.

As an aside, examples of successful regional restructuring and successful, quick convergence process are rare. Ireland is an example; Pittsburg may be another one. An important prerequisite for regional growth is that initiative and an optimistic mood prevail. This definitely holds for the majority of people in eastern Germany, but the PDS, the party of democratic socialism, alludes to people's feeling of being deprived and collects up to 20 percent of the votes.

There is no doubt, that German unification has been—in economic terms—a shock to the German economy. But it would be misleading to assume that this is the only reason for Germany's poor growth performance. German unification took place in an environment in which long-run trends were continuing on, leading to unresolved severe structural problems. Let us look at these issues in some detail.

3 Unemployment

Unemployment has ratcheted upward in the last thirty years in western Germany from 0.7 percent in 1970 to 11 percent in 1997 (8.3 in 2001) (Figure 3). In each recession, roughly one million persons were added to the unemployed in western Germany, and the high unemployment was not reduced during the boom years in a noteworthy way, so that the next recession started from a higher level of unemployment. Unification added the structural unemployment problems in eastern Germany.

The stepwise ratcheting upward of unemployment signals that the institutional design for labor is malfunctioning. Three major aspects should be considered in this respect: the first is the institutional design for wage formation, the second is the role of the reservation wage, and the third is the systematic weakening of the demand for labor.⁶

⁵ This applies to the overall tax rate, but also to the tax rates on industrial buildings and machinery (Commission of the European Communities 2001: Table 41).

⁶ As an aside, before I mention my critical points, the social partners have succeeded in introducing more time flexibility into the union contracts, thus exploiting an important source of productivity growth in the firms. This, incidently, has been obtained in a decentralized way through agreements in the firms.

Figure 3: Unemployment Rate in Germany



^aForecast of the Kiel Institute for World Economics.

The institutional design for wage formation. Wage formation is not left to the markets but determined by the social partners. The approach is to start wage negotiations for a specific sector in a specific region, and then to apply the negotiated wages to the other regions of the same sector. Usually, the wage contract of one sector is mimicked in the other sectors of the economy. As a result, wage differentiation is low relative to the United Kingdom and the United States, where the spread of wages has increased in the last twenty years.

Trade unions have not accepted what the German Council of Economic Advisers has proposed as an orientation for wage policy: in a situation of high unemployment, wages should not be raised according to the observed past trend in the growth of labor productivity but should remain below that trend in order to reduce unemployment. To put it differently, the expected increase in future labor productivity should not be calculated by dividing output by those employed but by also including the unemployed (4 million) and those in labor market schemes (1.7 million) in the numerator of the productivity measure.

Let us look in more detail at some of the legal stipulations. Negotiated wages apply to all firms that are members of the employer's association and to all workers who are members of the trade unions. De facto, firms do not differentiate wages according to union membership of workers or nonmembership. Moreover, the unemployment offices mediate jobs for the unemployed according to the negotiated wage (or the local customary wage). Thus, negotiated wages set the standard for the economy, even for the unemployed. Consequently, trade unions, which account for 19 percent of the active work force only and which are losing members, have a decisive influence on wages.

The institutional setup for labor and the role of trade unions may be difficult to understand in a country like the United States, where wages are overwhelmingly determined by market forces. The

clue to understanding the German setup is to know that the negotiated wage agreement is legally protected by a number of provisions. These stipulations prevent market forces from bringing about an equilibrium with less unemployment. They protect the insiders in their job, but they effectively discriminate the outsiders, the unemployed. They define a wage cartel which gives trade unions and employers' associations the right to set the wage, but they do not make them institutionally responsible for the quantities that will result in the labor market, i.e., employment and unemployment.

One basic legal principle, the so-called *Günstigkeitsprinzip* (the principle of the favorable solution), stipulates that the individual worker can deviate from the negotiated union wage contract if this is favorable for him. "Favorable," however, is interpreted in a narrow sense by the labor courts, namely as a higher wage than in the union contract or as less working time. The risk of becoming unemployed or the security of the job cannot legally be part of the consideration of whether to deviate from the union contract is favorable; this was explicitly decided by the highest labor court (*Bundesarbeitsgericht*) in 1999. According to this decision, wages and working time on the one hand and the security of a job on the other hand are not allowed to be compared, whereas any freshman of economics knows that the three variables wage level, working time, and the security of a job are strongly interrelated. This implies that efficient labor contracts are not feasible in the given institutional setting. To stipulate that the risk of losing a job should be taken into consideration or that the individual worker should have the right to decide for himself whether he wants to deviate from the union contract meets the strong opposition of the trade unions, who fear losing organizational power.

Another legal provision stipulates that firms cannot deviate from the union contract unless this is permitted in the contract itself (§ 77,3 *Betriebsverfassungsgesetz*).⁷ Thus, even if the workers in a firm agree overwhelmingly to work longer hours per week or to accept a lower wage, this is *verboten*. Again, decentralized efficient labor contracts are not possible. Admittedly, firms and workers have disregarded this stipulation to some extent. But legal battles in the courts have sustained the law that prevents efficient labor contracts.

The role of the reservation wage. A "social market economy" protects the individual when he is out of work, either because he is unemployed or because he is unable to work in case of illness or for other reasons. Germany has developed the following schemes:

Unemployment benefits of type I (Arbeitslosengeld) amount to 67 percent of the previous net income (unemployed with at least one child).⁸ The duration of benefits varies with age and lasts up to 32 months.

Unemployment benefits of type II (Arbeitslosenhilfe) amount to 57 percent of the net wage.⁹ It is paid when unemployment benefits of type I expire. This type of benefit is paid indefinitely. It is linked to the previous working income and requires neediness.

Welfare benefits (Sozialhilfe) are payments to those who cannot work. They are intended to allow a life in dignity and are defined by minimum requirements for living. They are means-tested. Compared to a worker, married with one child, welfare benefits make up around 70 percent of the lowest net wage in industry and approach 100 percent for low-paid professions such as in the restaurant branch.

Sickness pay amounts to 100 percent of the previous gross wage for the first six weeks and 80 percent thereafter.¹⁰

This set of government-provided incomes defines the reservation wage that an unemployed person requires from his next job; it influences search intensity and the willingness to accept a job. The higher the income provided by government when people are not working, the higher the reservation wage is.

⁷ This provision even applies to firms which are not members of the employers' association.

⁸ 60 percent for singles. Benefits are adjusted according to wage increases; they require a minimum time of contributions paid.

⁹ With one child, 53 percent in other cases.

¹⁰ It cannot surpass the net wage income. For the same illness, it is limited to 78 weeks in a three-year period.

Empirical analysis of the unemployed in Germany shows that the reservation wage amounts to 120 percent of the wage when previously employed (Christensen 2002). This is unusually high for someone who wants to find a job, and it is high in comparison to other countries. The reservation wage is not reduced with the duration of unemployment. This means that search intensity and the willingness to accept a job are low. The labor market dries up from the supply side. The supply curve only starts at the reservation wage.

At the same time, the described arrangements imply that neither workers nor their unions will accept a wage rate below the reservation wage. Thus, welfare benefits of the German type define a floor for the wage structure which prevents wage differentiation. There is an implicit minimum wage without a minimum wage being formally defined. This means that the lower part of the demand curve for labor is effectively truncated. There is no effective labor demand below the minimum wage. Such an economy loses the lower segment of the labor market.

Contributions to social security weaken the demand for labor. In addition to these institutional incentives, the demand for labor is systematically weakened for the following reason. The social security system is financed by contributions from labor income, paid by firms and by workers on a half and half basis. This implies a wedge between the gross and the net wage. The gross wage must be supported by labor productivity. If not, the contributions to the social security system have a similar effect as a tax on labor, weakening the demand for labor. Firms attempt to bring the gross wage in line with productivity. They can do this through various adjustments: lay off workers so that those employed have a high enough productivity to cover the net wage and the social wage, substitute capital for labor, look for labor-saving new technologies, and shift production abroad. When all these adjustments have taken place in a general equilibrium, unemployment results. Thus, the worker bears the burden of adjustment. Whereas the reservation wage affects the labor supply and the wage rate in the lower segment of the labor market, mandatory contributions to the social security system increase the costs of firms, which shifts the complete labor demand curve of the economy downward.

Lay-off constraints. Another aspect is that lay-off restraints and the practice to get around them with high severance pay represent an exit constraint that is anticipated by the firms; it also weakens the demand for labor. This exit constraint for those who are employed represents an entry barrier for the unemployed. The restraint is especially binding when in times of a crisis wages and working time are sticky downward for the individual firm.¹¹

To sum up, looking at this institutional arrangement, it seems that Germans cannot imagine that wages can be determined by the market, as is the case in other countries.

4 The Social Security Systems under Strain

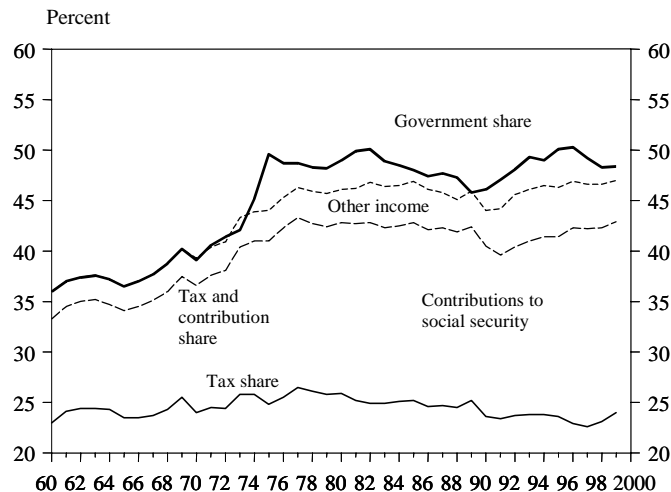
Germany is characterized by a generous social system which consists of the old-age pension system, old-age care, health insurance, unemployment insurance with two types of unemployment benefits, and social welfare. One-third of GDP is spent for the “social budget” (Siebert 2001a). Whereas part of the social budget is financed from tax revenue, the bulk of the expenditures is financed by contributions paid half and half by workers and employers. The financing of the system is thus linked to the labor contract.

There was a major expansion of the welfare state in the 1970s. The share of government in GDP rose from 39 percent in 1969 to 50 percent in 1980 (Figure 4). It was somewhat reduced in the 1980s

¹¹ Downward flexibility in working time with a reduction of pay can reduce the impact of lay-off constraints.

and went up to 50 percent in the 1990s, and now stands at 48.4 (in 2000).¹² The share of the contributions to the social security system has risen from 12.6 percent to 18.9 percent (1999). The expansion took place when the high real GDP growth rates of the 1950s and the 1960s of 7 and 5 percent could no longer be obtained.

Figure 4: Government Share in GDP^a



^aIn current prices; until 1990: West Germany.

Source: German Council of Economic Advisers, Annual Report 1998/99, Table 33*, and Annual Report 1999/2000, Table 27*; own calculations.

The marginal tax and contribution rate on income from labor is high: it amounts to 60 percent for the average earner (single earner, married, two children). Such high marginal rates represent wrong incentives for the work force to work and accumulate human capital. The negative impact on human capital accumulation is especially relevant in an information society, where human knowledge is the dominant source of economic growth. The existing arrangement thus hurts the growth dynamics and it may well be a reason for the loss of dynamics. Besides, it is an invitation to move to the underground economy or to officially take residence in low-tax places such as London, which is relevant for the modern services sectors (banking). In any case, here is a line of attack for economic policy that wants to overcome obstacles to economic growth. The impact of the contribution rates on the demand for labor and on the supply of labor via the reservation wage have already been discussed.

Government share and growth. It can be expected that the relationship between the share of government in GDP and economic growth follows an inverted U-shaped curve. An extremely low share of government in GDP can be expected to be associated with deficiencies in the legal framework of the market, i.e., high transaction costs due to uncertainty of contracts, a low level of internal security, and insufficient physical infrastructure. This has a negative effect on the productivity of the private sector that outweighs the negative impact of taxes. With an increase in the size of government, this overall negative effect can be expected to decline. If a certain size of the government is surpassed, the negative effect on work effort and on entrepreneurial effort begins to dominate. Apparently, government activity not only includes the allocation branch, which provides public goods and finances them through taxes, but also distributional targets, including the social security system. The task is to find the optimal size of governmental activity. Econometric studies suggest that in countries with an in-

¹² This development has been similar in other European countries, whereby some countries have reached much higher shares. The United States and Japan have a share below 40 percent (Heitger 2001).

tense involvement of government in the economy, a reduction in the government share will increase the growth rate (Heitger 2001).¹³

Controlling the increase in expenditures. So far, administrative attempts to control the cost increase of the social security system, for instance, in health care, have failed. Using such measures, the cost increase was halted for a year or two, but afterwards the increase resumed. It can be expected that administrative measures cannot control the cost increases. A solution would consist in distinguishing large and small risks for the individual. Large risks are those that cannot be borne by the individual, an example being a longer illness or disability. These risks have to be taken over by society; they require mandatory contributions. Small risks, like having no income in the first days of unemployment or illness, however, can be borne by nearly all members of society,¹⁴ for instance, by precautionary savings; they may also be covered by voluntary insurance. In my judgment, this distinction must be at the heart of reforming the welfare state. It must be applied to all areas of social security. Redistribution that is now part of the different branches of social security has to be shifted to the tax-transfer mechanism (Sachverständigenrat 1996); more equivalence has to be sought in the social security systems. By distinguishing between large and small risks, the mandatory contributions to the welfare system can be reduced. The negative impact on the demand for labor and the supply of labor can be meliorated.

Other aspects of the large share of government in GDP (incidentally, with a low and declining share of public investment in GDP) is to rethink the role of government in the market economy. Here Germany has been slow to privatize public firms such as telecommunications and the postal service in the past, and it would have been even slower without pressure from the European Union.

Finally, subsidies are a case in point. According to a survey of the Kiel Institute (Boss and Rosenschon 2000) using a wide delineation, subsidies account for €150 billion per year, that is, 8 percent of GDP, or 36 percent of total tax revenues.

The political economy of an aging society. All these issues become more relevant in aging society. Germany will be severely affected by the aging of its population, more so than France, the United Kingdom, and the United States. The average age (median of the population) will increase from 39.8 years (1999) to 48.6 years in 2050, assuming an annual net immigration of 200,000 persons. This will have severe repercussions for growth (labor supply will shrink), for the capital stock, the welfare state, and the political economy (Siebert 2001b).

5 The Regulation of Product and Capital Markets

Product market regulations play a role in generating or inhibiting economic dynamics. As already mentioned, Germany has been rather slow and late in deregulating and privatizing the telephone service. The regulation of biotechnology is another case in point. The licensing of new products and production procedures in specific areas like biotechnology and the granting of building permits, including investment projects are other examples.¹⁵ The regulations on the crafts may impede additional services and employment. Moreover, the rules specifying store closing hours, together with labor market regulations, partly explain why the service sector is underdeveloped in Germany. Finally, an indicator of product market regulations is that according to the Index of Governmentally Administered Con-

¹³ See also Lindbeck et al. 1994.

¹⁴ Those that cannot afford to save would be taken care of by governmental support, for instance, by social welfare.

¹⁵ Explicitly moving out of atomic energy is likely to have two negative implications in the future. First, it will put oil producers in an improved strategic position when world oil annual supplies are reduced according to a Hotelling scenario; oil producers will then have a higher threat potential because a credible backstop technology is lacking in the industrial countries. Second, it will make it more difficult to solve the CO₂ problem.

sumer Prices, calculated by the German Council of Economic Advisers, 34 percent of consumer prices are directly or indirectly administered.¹⁶

Another issue is the form of corporate governance and the role of the capital market. So far, banks, rather than the equity market, have dominated in the control of the boards of firms. This control has been a passive form in the sense that the bank representative intervenes to prevent unfavorable developments but lets the management do its business otherwise.¹⁷ This form of corporate governance may allow a necessary longer-run orientation of firms and it may therefore have its advantages. However, it is geared to the incumbent firms and not to the uncertain terrain of new firms. It is amazing that Germany has, in solving its structural adjustment problems, put emphasis on the existing firms, but not on new firms. The new firms are disadvantaged by the given institutional arrangements.¹⁸ Indeed, there are only a very few examples of new firms that have grown into large entities. The German approach to corporate governance may have been good in marginal improvements, for instance, in applying new production techniques to given goods, but it is deficient in leapfrogging to new approaches and completely new products.¹⁹ The German system of corporate governance through banks is now starting to experience the impact of globalization. Banks are coming under the increased international pressure of intensified competition, limiting their possibilities to provide credits to firms in trouble for national or political reasons. Banks are becoming weaker in defending the "Deutschland-AG." Thus, more competition between banks indirectly has a similar effect as an equity market would have.

With respect to human capital, the institutional arrangement of the apprenticeship system is an asset. It combines learning on the job with formal education. It also is an important mechanism of socialization of young people into society and of integrating them into the labor market. In contrast, the institutional arrangements for the university system and for large-scale research institutes are deficient. The university system is steered with governmental planning measures such as capacity regulations as to the student load that universities have to take in and other bureaucratic procedures. In areas where capacity is lower than the number of students, a central governmental agency allocates the scarce slots to the students. As in the labor market, Germans like to believe in "Behörden," in governmental agencies. It appears to be beyond the imagination of public opinion in Germany and of many politicians that competition can and must be the relevant approach to organizing the university system. Many Germans have no confidence in competition and in the market process. However, the most important ingredient of an approach with which to achieve a higher growth path is to revamp the German university system and organize it according along the lines of competition. So far, equity considerations hinder politics in following this alternative.²⁰ Here a sea change in the orientation of politics is necessary.

¹⁶ Sachverständigenrat (2001/02: Table C1).

¹⁷ The insolvency of Holzmann and Kirch are examples where this type of control has not functioned.

¹⁸ This also holds for the tax reform, pursuant to which retained earnings receive preferential treatment.

¹⁹ The venture capital market has improved.

²⁰ A central argument against opening the university system to competition is the fear that the equity goal will be violated in that children of workers will then find it harder to enter universities. Of course, such an effect has to be prevented using an open system of entry that does not favor income or inheritance and that, for instance, provides stipends for talented people based on a means-blind admission policy. But it is simply wrong to assume that the actual system without fees is equitable. With respect to taxation, workers contribute a much larger share to financing universities than the share of workers' children in universities (Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, *Jahresgutachten* 1998/99: 251).

6 The Consensus Approach

The social market economy. The original concept of “the social market economy” in the Erhard interpretation attempted to reconcile efficiency and equity. An underlying idea is that the benefits of economic progress should be widely distributed and go to all or at least to the wide majority of people and that necessary economic adjustments should be eased by social considerations and the appropriate institutional safeguards.

The concept has been relevant for all areas of economic policy, wherever equity ideas are involved. This holds for product market regulation which protects existing jobs (for instance, in the traditional postal service, including telecommunications) even if new jobs are prohibited (in new areas of telecommunications). The concept also holds for the labor market institutions, where insiders are protected, but where by the same protection market access for the outsiders is restricted. It holds for the social welfare system, for taxation policy, and even for not allowing competition as a basic element of organizing the university system. It also has been used to justify subsidies; they cover up some of the adjustment problems. The issue for Germany today is to what extent the application of this concept of “social market economy” has meanwhile had a negative impact on economic dynamics in the long run, so that the economic basis for social programs becomes weaker and weaker.

The consensus approach. An important aspect of the German system related to the social market economy is a consensus approach in which the explicit or implicit agreement of many groups of society is sought when important policy measures are taken. This is typical for the round tables and committees used by Chancellor Schroeder, such as the “Alliance for Work,” but it is also typical for the two layers of decision-making in the firms, that is, codetermination in the boards of larger firms as well as the workers’ councils in the firms. Finally, the consensus approach is dominant in both major parties. It even holds in the election year 2002, where the opposition hesitates to point out the changes necessary for Germany.

The consensus approach may sound rather humane, at first glance, but it has serious shortcomings. With respect to organized groups, a constitutional question is to what extent the parliament loses power to organized interest groups. Another question is that the status quo plays an important role in the consensus approach. Major changes are not accepted when important groups in society are negatively affected by such changes. In a way, the consensus approach is an application of the Pareto criterion used by economists, according to which an increase in welfare presupposes that at least one wins and no one loses, with the difference that in politics a relative loss is considered a loss as well. This implies that a standstill is often the outcome, that economic dynamics disappear.²¹ Decisions tend to be blocked if you look for consensus and distribution only.^{22,23}

²¹ See “D-Land, einig Stillstandland,” *Die Zeit*, January 24, 2002.

²² The present government has introduced three major laws that go in the direction of modernization: the tax reform, the limited switch to partial private funding of old-age insurance, and the immigration law. Some tiny reforms of the previous government have been undone, for instance, in health insurance and the lay-off law as well as other areas. The labor market has been re-regulated by a set of new laws. Industrial relations (co-determination) have also been additionally regulated, which has not been well received by the smaller and medium-sized firms of the German *Mittelstand*. The welfare state has not been modernized, especially with respect to health insurance. Burden-sharing between the federal states has not been changed in the sense of a competitive federalism. After the tax reform, Germany’s business taxes are still high relative to other EU countries. The tax reform favors existing firms and physical capital (not human capital). The pension reform may prove not to be viable in the long run. It is open to what extent the new immigration law will be implemented in the form of an explicit immigration policy where the (economic) interest of the immigration country dominates in choosing those who immigrate.

²³ This will be a major issue for a constitution-like arrangement for the European Union. If equity and distribution dominate, a blockage is the likely outcome (Siebert 2002a).

An important shortcoming is that such an approach does not make use of the decentralized institutional change²⁴ in which new developments occur more or less automatically and where new ways to do things, i.e., institutions, can be found spontaneously in a Hayekian sense to adjust to the new economic conditions. Round tables do not have an automatic and decentralized way to find new institutional solutions. They are concerned with formally establishing and adjusting the rules. Such a system does not make use of the problem-solving capacity of decentralized and spontaneous change.

Short-termism and adhocery. An issue related to the consensus approach is interventionism where the politician solves acute economic problems in a “fire-brigade” approach on an ad hoc basis. In an environment where the interest groups have an important say, they tend to expect the government to solve specific and unusual economic problems by means of a tailored intervention. This can be expected to lead to adhocery, to a short-run orientation, and to inconsistency in economic policy. “In the long run, there is just another short run,” as Abba Lerner once said. More fundamental restraints are likely to be put on the back burner, for instance, long-run impacts of economic policy measures, issues of sustainability, and intergenerational budget constraints. In such an approach, the politician does not lead. As Churchill answered when asked what makes the difference between a politician and a statesman: “A politician always thinks of the next election, a statesman considers the next generation.”

Distributive federalism. German federalism also shows strong elements of equity and consensus, for instance, by requiring similar conditions with respect to public infrastructure in the regions of the country. This is often interpreted as similar living conditions in each of the federal states. German federalism is not a competitive federalism where states compete for the mobile factors of production, capital, technology, and highly qualified labor, and where locational competition points out the best solutions. It is a distributional federalism where the tax revenue of each federal state is brought to nearly 100 percent of the average in a transfer-scheme between the states (and the federal level). Burden-sharing between the states, a key concept, does not set the right incentives for states to develop their own tax base and business base.

Consensus under conditions of expansion. The consensus approach probably did not do too much harm in an environment of high growth rates of 7 percent, as in the 1950s, and 5 percent, in the 1960s, when the German economy was catching up to the United States and when welfare gains could be spread widely. In a situation when the annual growth rate is around 1½ percent, restraints become more binding and goal conflicts more biting. This raises the question whether the institutional setup for decision-making is part of the German problem of low growth performance. In that sense, Germany may face a similar problem as Japan, whose institutional system was appropriate for an expanding economy, but no longer seems appropriate to solving structural issues.²⁵

Other institutional arrangements are relevant as well in this context. For instance, with respect to the workers’ councils the question can be raised as to what extent this decision process is appropriate for an economy that marginally improves the existing production technology and modernizes established products. But such an approach may be inappropriate in an environment where a new technology has to be applied and where new products have to be developed.²⁶

I am concerned by the question to what extent a country like Germany becomes immobile with respect to institutional modernization. Is this the fate of a mature economy that can no longer solve the major economic policy issues? Have structures become so rigid that institutional adjustment can no longer take place. Has the political process lost its problem-solving capacity? And must it rely more and more on decisions of the Constitutional Court to resolve deadlocks? Can Germany be compared to

²⁴ Competition and markets are a method of decentralized change. If the market is restricted by many rules that specify what cannot be done, decentralized change is prohibited.

²⁵ The relative overrepresentation of agricultural voting districts to the city districts of Japan finds its analogon in the consensus approach in Germany.

²⁶ On the necessary changes, see Siebert (2001a and 2001c).

Japan as another mature economy? Are these two countries the newly declining countries of the world economy?

These questions are especially relevant in a situation where other countries have undertaken major changes in their institutional arrangement. This holds for the Netherlands since 1982, for Ireland, for the United Kingdom, and even for the United States in the 1980s. In such an environment, the relative position of a country remaining immobile institutionally is negatively affected.

7 Conclusion: Germany as an International Player

The picture of Germany that I have painted may help you to understand Germany's role in the international community. Germany has been a driving force in the political integration of the European Union in the last fifty years, including monetary union. Policy instruments have been shifted to the EU level, for instance, in trade policy, competition policy, but also in product market and capital market regulation and environmental policy. In the current EU constitutional debate, Germany seems to be more prepared than other countries, such as France and the United Kingdom, to give up national sovereignty to a European Parliament. Of course, the new economic conditions mean that Germany can no longer foot the European bill if EU compromises have to be paid for using German cash.

Internationally, Germany is prepared to play its role in international organizations such as the WTO and in pushing forward global environmental treaties.

The need for a renaissance of the market economy. My portrait of a Germany with a loss of economic dynamics, high unemployment, and an over-extended welfare state does not mean that existing German firms are not efficient. They are, but they have maintained their competitiveness by shedding labor, by creating jobs abroad. In addition, they seem to prove their competitiveness more abroad than at home. What is needed are more new firms and more firms in new areas. Note that firms may be competitive whereas a location, "Standort Deutschland," may not.

Whereas the existing firms are efficient, the institutional frame of reference defined by the political system seems wanting. It is not sufficiently geared towards innovation and modernization. Maybe the optimistic answer is that the Germans as a people are resilient, that in terms of economics they are good when they have their backs against the wall and that they are not yet in that position. To bring this strength forward, Germany needs a renaissance of the market economy.

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To conclude, Germany is facing quite a few severe economic policy challenges. In my heart I am an optimist, and of course I hope that Germany will find solutions for all its problems. To close with an optimistic tone, maybe a country should keep in mind what Calvin Coolidge once said: "If you see ten troubles coming down the road, you can be sure that nine will run into the ditch before they reach you."

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