Paqué, Karl-Heinz et al.

Working Paper — Digitized Version

Challenges ahead: Long-term perspectives of the German economy

Kieler Diskussionsbeiträge, No. 202/203

Provided in Cooperation with:
Kiel Institute for the World Economy – Leibniz Center for Research on Global Economic Challenges

Suggested Citation: Paqué, Karl-Heinz et al. (1993) : Challenges ahead: Long-term perspectives of the German economy, Kieler Diskussionsbeiträge, No. 202/203, ISBN 3894560444, Institut für Weltwirtschaft (IfW), Kiel

This Version is available at:
https://hdl.handle.net/10419/764

KIELER DISKUSSIONSBEITRÄGE

KIEL DISCUSSION PAPERS

202/203

Challenges Ahead

Long-Term Perspectives of the German Economy

by Karl-Heinz Paqué, Rüdiger Soltwedel et al.

INSTITUT FÜR WELTWIRTSCHAFT KIEL · MÄRZ 1993

ISSN 0455-0420

Challenges Ahead

Long-Term Perspectives of the German Economy

by Karl-Heinz Paqué, Rüdiger Soltwedel et al.

INSTITUT FÜR WELTWIRTSCHAFT KIEL · MÄRZ 1993

ISSN 0455-0420

Die Deutsche Bibliothek - CIP-Einheitsaufnahme

Challenges ahead: long-term perspectives of the German economy / by Karl-Heinz Paqué, Rüdiger Soltwedel et al. Institut für Weltwirtschaft Kiel. — Kiel : Inst. für Weltwirtschaft, 1993

(Kiel discussion papers ; 202/203)
ISBN 3-89456-044-4

NE: Paqué, Karl-Heinz; Institut für Weltwirtschaft <Kiel>; Kieler Diskussionsbeiträge

ISSN 0455 - 0420

Contents

Preface

The Cellule de Prospective — a task force of the European Commission that is attached to the President, Jacques Delors, and whose mission is to research and produce new ideas on the medium- and long-term prospects for European integration — has asked twelve national think tanks, one in each member country, to provide a forward-looking overview of the main economic, political and social shaping factors that will govern the future and reflect the specific sensitivities of their respective countries, and to assess the implications of these factors for the European Community. On the basis of the national institutes' and additional experts' contributions, Alexis Jaquemin and David Wright have edited a book entitled "The European Challenges Post-1992: Shaping Factors, Shaping Actors".

The Kiel Institute of World Economics was invited to present the German view. This discussion paper contains the complete text of the Kiel Institute's contribution to this brain-storming exercise. It is a joint product not just of the two main authors, Karl-Heinz Paqué and Rüdiger Soltwedel, but of a large number of colleagues at the Kiel Institute, who made substantial contributions to the text. In allocating authorship to the different parts of the study, the following picture emerged: "The Transformation of Central and Eastern Europe" (Section I.1.) was written by Holger Schmieding, "Migration Pressures" (I.2.) by Rüdiger Soltwedel, "The Multilateral Trading System" (I.3.) by Ulrich Hiemenz and Rolf J. Langhammer, "Industrial Policy" (I.4.) by Henning Klodt, "The Adjustment of Agriculture" (I.5.) by Jörg-Volker Schrader, and "European Integration" (I.6.) by Joachim Scheide (on monetary union), Ernst-Jürgen Horn (on financial markets) and Rüdiger Soltwedel (on EC social policy); "German Unification" (II.1.) was written by Karl-Heinz Paqué (with a digression on the Treuhand by Rainer Maurer), "Demography and the Welfare State" (II.2.) by Alfred Boss and Rainer Schmidt, "Labour Markets and Collective Bargaining" (II.3.) by Karl-Heinz Paqué, "Energy and the Environment" (III.1.) by Axel D. Neu, and "Transport" (III.2.) by Hans Böhme and Claus-Friedrich Laaser. Thanks are also due to Johannes Heister, Konrad Lammers, Klaus-Werner Schatz, and Klaus-Dieter Schmidt for various inputs into the project.

Kiel, March 1993 Horst Siebert

Executive Summary

Global Factors

A General Assessment

The world is presently facing two major, urgent challenges, namely (i) the transformation of central and eastern Europe after the end of the cold war, and (ii) the uneven demographic and economic development throughout the world.

(i) After the collapse of the socialist regimes, the former communist world faces a challenge of historical dimension, namely to simultaneously organize a change from totalitarianism to democracy, from a centrally planned economy to a decentralized market economy, and from a regime of political subordination to the ruling Soviet elite to national independence and self-determination. For this historically unique experiment to be successful, it is imperative not to disappoint the expectations of an improvement in living standards on which integration into the West European mainstream is contingent. The keystone for the world's, and foremost Europe's, security and well-being is economic recovery in Eastern Europe. It is obvious that Eastern Europe will have to go through a severe adjustment crisis before a strong and self-sustained economic upswing can set in. This upswing will be very uneven among and within the respective countries, with some countries, regions, and sectors remaining engulfed in a deep crisis, eventually jeopardizing the recovery process.

(ii) The most immediate threat, as it is perceived by the public at large in Europe, is a deluge of immigration in the wake of the geopolitical events in the East. However, the often-mentioned nightmare of up to 40 million people besieging an immigration-adverse "Fortress Europe" is more of an illusion than a realistic scenario. Whether it will happen at all will depend on the further evolution of the transformation process and on the economic, political, social, and ethnical disruptions this process may entail. In the long run, high fertility rates, political turmoil, and grim economic prospects in the developing countries of Asia and Africa may create an explosive situation. Hunger and despair in these countries may ultimately motivate violence and fundamentalist salvation movements hostile to the evolution of market institutions, further worsening their prospects for integration into the world economy. From a European perspective, it is already evident that developments on the southern rim of the Mediterranean will lead to greater migration from south to north than from east to west. Hence, whereas immigration from Eastern Europe will rise substantially throughout the next decade or so and taper off thereafter, immigration from the southern rim of the Mediterranean will increase far into the next century.

These challenges, which affect economic, social, and political life at the same time, lead to two major conclusions that hold for the community of industrialized countries as a whole:

- Euphoria because of the self-defeat of communism has calmed down as a result of the recognition of the tremendous adjustment costs arising from the transformation process; it will be costly to preserve peace while at the brink of chaos — cashing-in on the "peace dividend" is still far away.
- In order to avoid the disintegration of the world economy and make room for self-sustained development of poor countries in the East and in the Third World, international policy co-operation is needed to keep markets open. Co-operation may help national governments to find a way out of their commitments vis-à-vis domestic interest groups and reduce the distortions in the international allocation of resources.

In any event, these challenges suggest that the times ahead will be difficult because of, on the one hand, higher costs of maintaining peace and keeping the growth process going and, on the other, higher expectations that income and wealth will be redistributed. However, one should not lose sight of the fact that easing the pain of transformation process in post-communist countries, reducing distortions in international trade, and preserving the environment will pay off in the long run.

The German Perspective

The transformation of Central and Eastern Europe will have far-reaching repercussions on Germany. Germany is particularly exposed to migration from Eastern Europe because of differences in living standards, geographical proximity, and to some extent, cultural affinity. And given the high degree of openness of the German economy, it is of extreme importance whether it will be possible to stem the rising tide of protectionism in the international trade regime.

The Transformation of Central and Eastern Europe. Germany is likely to be affected more than other EC countries by the transformation process in Central and Eastern Europe, both with respect to the transition problems and the long-run growth prospects of the Central and Eastern European countries. Germany will be an important trading partner and a major source of foreign direct investment for the East. It will also be the country most directly exposed to security risks, be it the malfunctioning of nuclear power stations or the outburst of political conflicts. Hence, within the EC and beyond, Germany will become the natural advocate of the concerns of the Eastern European countries, an advocate whose population may be slightly more prepared than others to trade off short-run sacrifices against the long-run benefits of opening up to the East. However, intensified East-West trade as a result of freer market access for Eastern products will hit the traditionally protected sectors of the German economy the hardest, namely agriculture, coal mining, steel, and textiles, so that major German lobbies may have to fight widely shared political imperatives much more so than they did in the past.

Migration Pressures. There is a clear indication that the EC member countries in general and Germany in particular will have to change from being de facto immigration countries to being de jure immigration countries and will, thus, have to recognize the need for an immigration policy. In doing so, it will be necessary (i) to disentangle humanitarian refugee policy from immigration policy, which is basically part of general economic policy; and (ii) to clearly define criteria for taking in additional immigrants — by no means an easy legislative task. However, it will become increasingly clear that the immigration threat will, to some extent, turn into relief once the demographically determined aging of the Western European societies — with Germany taking the lead — starts causing growth-impeding labour market shortages and a substantially heavier age burden. Nevertheless, immigration policy will not suffice to lastingly reduce emigration pressures in the source countries. To this end, the international trade policy regime is far more important.

The Multilateral Trading System. The German government has long been committed to an open international trading environment and most-favoured-nation (MFN) treatment. There are no indications that this basic trade policy stance has changed or will change in the near future, despite the rather passive role that Germany has played in the Uruguay Round until recently. However, the government's view does not necessarily reflect a consensus in society: obviously, the well-organized agricultural lobby opposes any trade agreement that would require further adjustment in the agricultural sector. And industrial lobbies are having second thoughts about whether this attitude pays off, especially under the mounting pressure of Japanese competition in important branches of manufacturing such as motor cars and electronics.

Industrial Policy. Industrial policy is likely to become one of the most controversial topics in the future discussion of economic policy in Germany. At present, resistance to industrial policy seems to be weakening, as a growing part of the political establishment feels increasingly attracted by the ideas of strategic industrial policy. Even despite the rather poor record of industrial policy in the past, it can be expected that the ongoing shift in attitude in German industry will eventually translate into a corresponding shift in government policy. The result could be a certain reconciliation in the design of future EC policies between the traditional German position and the more *étatiste* Franco-Roman standpoint on the role of state interventions. The outcome could be a division of labour in industrial policy between the German government, which would concentrate on programmes for mitigating structural unemployment, and the Commission of the EC, which would focus on the support of advanced technologies and strategic industries.

Specifically German Factors: The Legacy of Unification

Economic Consequences

In economic terms, German unification will change the country in at least three major respects: (i) it will add considerably to the fiscal burden of the public sector for a prolonged period of transition — maybe more than a decade — and thus damage the traditional reputation of Germany as a haven of fiscal conservatism; (ii) it will lead to a kind of dual economy in the east, with a hypermodern industrial sector next door to a heavily subsidized old one, and with high structural unemployment; and (iii) it will change the regional pattern of growth prospects, roughly speaking from the traditional growth poles in southern Germany towards the north and Berlin.

The Rising Fiscal Burden. The economic costs of unification were vastly underestimated by politicians and large parts of the public. The great public tasks — setting up a modern physical and administrative infrastructure, mitigating disastrous environmental damage, privatizing and restructuring a decrepit industrial capital stock, and supporting a rapidly rising number of unemployed people within the framework of the generous western German welfare state provisions — have turned out to be much more expensive than expected, not least because the collapse of production in the east has surpassed all prior predictions. The drastic increase in public expenditures was at first regarded to be strictly temporary. However, all economic indicators now show that this will most probably not be the case, so that the steps taken so far — the sharp increase in the petrol tax, the increase in the standard value added tax rate from 14 to 15 per cent in 1993, the imposition of a (temporary) income tax surcharge for twelve months and the increase in payroll taxation — will not be remotely sufficient to balance the books in the medium and long run. Further tax increases are already on the political agenda.

In any case, the question of consolidating public finances will become something of a permanent theme again in German politics, as it used to be in the late 1970s and early 1980s, with the likely outcome being some rather ad hoc combination of expenditure cuts in the western part of the country (especially in subsidies), a postponement or watering down of further tax reductions, notably on business profits, some further tax increases, and, most importantly, a permanently higher fiscal deficit.

Economic Dualization. By the mid-1990s, a dual economy will emerge in the east, consisting of a rather modern, highly capital-intensive segment and a subsidized old one with long-term unemployment remaining much higher than in the west. The basic reason for this is that collective bargaining in united Germany has opted for a very rapid equalization of wages between the west and the east in major industries by 1994, despite the vast and obvious labour productivity differential. These terms reflect an endeavour to prevent mass migration and wage competition. The burden of creating incentives for private investment in the east has thus been put on public aid. The federal government in fact swiftly provided a large and generous menu of investment aid items augmented by comprehensive labour market measures to mitigate social disruptions resulting from the adjustment of hopelessly overmanned enterprises. In the medium and long run, this emergency aid will be fiscally unsustainable and will give way to more moderate aid packages. In addition, even if the Treuhandanstalt (the holding company that owns East German formally state-owned enterprises) finishes up its prime task of privatization on schedule, i.e. in about two years time, there will no doubt remain a significant residuum of unsaleable industrial capacity that will be heavily concentrated in certain eastern industrial regions. Pressures are mounting for this capacity to continue to operate at high rates of subsidization. Hence, while the transformation of the eastern economy may be basically successful in initiating a sustained revival of industrial activity, it is unlikely to be powerful enough to lead to a full-scale reintegration of the eastern workforce at western wage levels.

New Regional Growth Patterns. With the re-establishment of trade and transport links to eastern Germany, the artificial handicaps of locations along the former Iron Curtain have disappeared or will disappear in due course. In fact, from the standpoint of a potential investor, some of the previously handicapped locations now enjoy distinct advantages. This is certainly true for the capital, Berlin, which, apart from becoming the seat of the German government, now finds itself geographically well placed to resume its pre-war role of a metropolis between Eastern and Western Europe. This is also true for the industrial areas at the former inner-German border, e.g. in eastern Lower Saxony, northern Hesse, and northern Bavaria, which have changed from being on the eastern periphery of West Germany to being central regions of a united Germany, with a complementary industrial hinterland in the eastern states of Brandenburg, Saxony-Anhalt, Thuringia, and Saxony. The most likely losers in this reshuffling of growth potentials will be precisely those regions that profited most from the division of Germany in the first place, notably southern Bavaria and the Rhine valley: many firms may return their headquarters from Munich, where they had moved after World War II, to their traditional home in Berlin, and many government-close service branches are likely to follow the trek of bureaucrats and lobbyists from the Cologne-Bonn urban area to the new (and former) capital. Within eastern Germany, the industrial heartlands of the pre-war period, which are in the states of Saxony, Saxony-Anhalt, Thuringia, and southern Brandenburg, will enjoy locational improvements similar to those enjoyed by their counterparts in Lower Saxony, Hesse, and northern Bavaria. The economic prospects will look gloomier for the northern regions of eastern Germany, especially Mecklenburg-West Pomerania, which will remain the poorhouse it used to be in the pre-war period. Although Berlin is likely to resume its pre-war role as an industrial and administrative center, it is unlikely to attain such a predominant role as to undermine the post-war tradition of strong political and economic federalism. Berlin could well become an important growth pole in the east — a kind of counterweight to the Rhine/Ruhr industrial powerhouse in the west — but it will certainly not develop the centripetal power of Paris in France.

Sociocultural Consequences

German society at large will have to meet new challenges as a result of unification and the fall of the Iron Curtain. Being firmly rooted in Western values of individualism and democracy, it will find itself again at the East/West crossroads of ideas and cultures that are now undisturbed by physical and ideological barriers; faced with a persistent inflow of genuine immigrants from Eastern Europe — not just with periodic waves of "guestworkers" who keep their roots in the respective countries of origin — it will gradually turn into a kind of multicultural society, at least in the large urban centres where the immigrants tend to settle first. Thus, Germany may become a bit less "Swedish" and a bit more "American" in its basic sociological structure. While, in the long run, a more heterogeneous society is likely to be more dynamic and colourful than a homogeneous one, it also poses a much larger package of social problems that will have to be tackled with a spirit of urban tolerance that has not been a typical characteristic of Germany so far. Much of the success of Germany's new cultural role depends on whether such a cosmopolitan outlook will develop pari passu with the influence of ideas and the inflow of people from abroad.

Challenges for the European Community

There is no time for complacency in the Community after the completion of the single common market and the first steps toward political union. In order to measure up in post-communist Europe to its historical role as a model and a catalyst for peaceful co-operation and as one of the major economic players in the world besides the US and Japan, the EC will have to sharpen its profile not only in economic matters but also in the realm of policy issues. In the political arena, the challenge of defining and implementing a common security policy stands out. Security policy is crucially and intricately intertwined with success on the economic front; economic recovery of the post-communist states is the keystone for a peaceful process of transformation in these countries and is thus also a matter of importance to EC security policy; and brightening up the grim economic prospects at the southern rim of the Mediterranean with its rapidly growing population is a *conditio sine qua non* for keeping fundamentalist revolutions at bay.

In order to fulfill its function as a model and a catalyst, the EC will have to harness the further development and consolidation of its own institutions. A conspicuous case in point is overcoming the democratic deficit as well as the lack of transparency in, and low efficiency of, its decision-making process. The Community will have to work towards making the citizens of the member countries feel like citizens of the United States of Europe and, at the same time, preserve the social, cultural, and political roots of the citizens in their local, regional, and national environments. The principle of subsidiarity is of utmost importance in this context, although it is as yet far from being well defined and clearly understood.

In the realm of macroeconomics, the pursuit of the stability of the value of money, and hence the guaranteed independence of a central bank, is crucial for the lasting economic success of the Community. Furthermore, it is important not to overburden the taxpayers for the sake of social cohesion and coherence. The increasing importance of social and regional policy at the EC level raises a complex set of efficiency issues, not least the question of aid dependency.

The further deepening of the Community may foreshadow a reduced willingness of the EC to remain open to the poorer countries of Europe for whom admission to mainstream Europe is crucially important to avoid a setback in their economic and democratic development. The widening of Europe, often perceived as a political imperative, may clash with the top-down approach of a further deepening of the Community.

One of the most important challenges for the Community is to stem the rising tide of protectionism, to which it has itself — albeit not alone — contributed strongly throughout the 1980s by causing severe distortions in the field of agricultural trade and by straining the GATT rules in the trade with industrial products. In that respect, a more forthcoming policy is needed to successfully conclude the Uruguay Round. But, there is a risk that the enlarged mandate of Maastricht will give momentum to more or less harmful strategic policy interventions.

I. External Challenges

1. The Transformation of Central and Eastern Europe

a. Trends in Central and Eastern Europe's Emerging Market Economies (EMEs)

The quest for close economic, political, and even military integration with Western Europe (EC, NATO, WEU, CSCE, and OECD — in descending order of importance) is likely to continue. Even apart from considerations of market access, major segments of the new ruling elites in the EMEs perceive East-West integration as an important means to stabilize the nascent institutions, forestall a slide into economic interventionism and political authoritarianism (the "Latin American spectre"), and partly fill the power vacuum left behind by the collapse of the Soviet Union. This sentiment is and will be shared by major parts of the population in the EMEs. Of course, the person in the street puts more emphasis on the improvement in living standards that integration into the EC is expected to bring about than on less down-to-earth aspects of institutional stability and national defence.[1]

Yet, in the coming years, rising nationalistic sentiment is likely to spur a temporary anti-EC (and anti-German) backlash in those EMEs where the economic crisis continues. This backlash may be quite severe if populist politicians in the EMEs succeed in portraying two aspects of an eventual accession to the EC as major hazards for their countries: the free flow of capital ("sell out to foreigners") and the free movement of people ("the return of expelled Germans").[2] Nonetheless, the backlash will be temporary as the fears on which it is based will turn out to be unfounded and will subside.

Association agreements such as the ones that the EC has concluded with Poland, Hungary, and former Czechoslovakia are a temporary halfway house at best; even improved accords of this kind will not satisfy the Central and East European aspirations for full participation in the West European mainstream. Regional integration arrangements and regional trade links between the EMEs may complement but cannot substitute for the desired admission into the West European mainstream; co-operation between the westernmost EMEs (Poland, the Czech Republic, Slovakia, Hungary, Slovenia, and Croatia) may serve to coordinate the stance of these countries in negotiations with the EC and NATO; it will not be seen as a major end in itself. The relations between the westernmost EMEs and other EMEs, notably Serbia and the successor states of the Soviet Union, may well be far too strained to allow for even a minimum coordination of policies between these countries.

By now, the notion has become commonplace that the EMEs have to go through a severe adjustment crisis (stage 1) before a strong and self-sustained economic upswing will set in (stage 2). This economic upswing in the EMEs will be very uneven, with some regions and sectors growing vigorously while others remain engulfed in a deep crisis. By and large, the recovery will be based on two major factors: (i) on the growth of small and medium-sized firms and of newly established private enterprises that are outperforming the already existing large firms, be they privatized or not, and (ii) on the rise of exports to the West, notably to Western Europe.

Precise numerical forecasts for the EMEs are impossible to make, not least because the true GDP of the EMEs is still unknown. Even in those EMEs like Slovenia, Hungary, Poland, and the Czech Republic, in which true GDP (including the new private sector that is not fully recorded in the official

1 On popular attitudes in the EMEs towards the EC and other Western institutions, see Commission of the EC (Ed.), Central and Eastern Eurobarometer, No. 2, January 1992.

2 This apprehension is of course almost completely unfounded. Few second- and third-generation expellees will want to sacrifice their comfortable life in Germany to return to the homes of their forefathers. At most, those expellees who are still genuinely interested in their former home regions may be particularly inclined to purchase holiday cottages on the shore of the Baltic Sea, around the lakes of former East Prussia, and in the mountains of Silesia.

statistics) may soon start to grow, unemployment is likely to increase substantially for some time to come. Hence, the population may perceive the early phase of the recovery as an ongoing crisis.

The transformation process in the EMEs is an institutional revolution. The institutions of socialism are vanishing; the new institutions of capitalism are gradually being established. The length and depth of the transformation crisis will depend more on the rapid consolidation of market-conformable institutions and on the emergence of business-oriented attitudes of the population than on factor endowments in the classical sense (natural resources, labour, capital, technology) and on the details of the chosen transformation strategy. All in all, the prospects for a rapid improvement in economic terms are roughly proportional to the distance from Western Europe and to the time that has already passed since the first major institutional changes were introduced. Comparatively speaking, prospects are the brightest for Slovenia and the Czech Republic, where vigorous GDP growth may set in within less than two years; the outlook is almost equally positive for Poland and Hungary (although both may have to go through another programme of macroeconomic stabilization to cut the soaring budget deficit), the economic situation is likely to remain rather fragile in Slovakia and Croatia and even more so in Bulgaria, Romania, and the Baltic states; in the bottom league are Albania, Bosnia-Herzegovina, Macedonia, Serbia, and the non-Baltic successor states to the Soviet Union. Naturally, this economic ranking is roughly identical to a ranking along the lines of political stability.

The major economic hazards for the EMEs are soaring budget deficits that will eventually have to be monetized and the gradual emergence of powerful and aggressive special interest groups that, in the absence of adequate safeguards, may succeed in partly stalling or reversing the deregulation and liberalization of the economy. Because of the next-door example of prosperous and (more or less) capitalist Western Europe, at least the countries in the first two groups (and probably also Slovakia, war-torn Croatia, and the Baltics) are likely to eventually overcome any populist temptations, to continue or resume the transformation to capitalism and to narrow the gap in East-West living standards. In less than two decades, the East-West difference in average per-capita income may approximate that of pre-communist times.

The division of labour between the EMEs and Western Europe will not only intensify dramatically but also change in nature. The change in the product composition of East-West trade will take place in two stages. In the aftermath of the first major transformation steps, the EMEs are presently discovering what their genuine comparative advantages are at their present factor endowment. These advantages lie not in sophisticated and high value added manufactures but rather in raw materials, food products, and low value added manufactures, notably in resource-based and in labour-intensive manufactures. Hence, the production and export structures of the EMEs are now changing in a "retrogressive way", i.e. becoming somewhat more similar to those of developing countries and less similar to those of developed industrial countries. This first stage will last until the present capital stock in the EMEs has been augmented considerably by new investment. In the second stage, the share of high value added manufactures in EME output will rise substantially; the present trend towards an inter-industry division of labour with Western Europe will then be reversed, and an intra-industry pattern of East-West trade will gradually emerge.

Those EMEs, in which the political situation appears to be sufficiently stable, are and will continue to be attractive locations for foreign investors. The overall amount of foreign investment will depend far less on the internal economic policy of an EME than on the policy of the EC towards this EME. The more the EC improves market access for products originating in the EME, the more investors who want to serve the West European market will choose the EME as the appropriate location for production. At the same time, the inter-regional disparities within individual EMEs will induce a considerable internal reshuffling of the labour force. Some of these migration movements will spill over into Western Europe (see Section I.2 below).

b. The Impact on Germany

Broadly speaking, the impact on Germany will reflect the two stages of the transformation process in the EMEs. In the short and medium term, i.e. roughly in the coming three to six years, the consequent political, social, and economic adjustment problems in Germany may even outweigh the economic gains that Germany can already reap from the opening of Eastern Europe; once major East European countries have left their own adjustment crises well behind, Germany will benefit hugely from the economic re-emergence of its eastern neighbours.

Because of size, living standards, geographic proximity, and — to some extent — cultural affinity, Germany will be affected far more than other EC members by the short- to medium-run problems and the long-run prospects for rapid growth in most EMEs. It goes almost without saying that Germany will be the most important trading partner and a major source of foreign direct investment for most EMEs. The share of trade with the East in overall imports and exports may skyrocket from 4 per cent (for old West Germany) to 10 per cent for the new Germany by the turn of the century; ultimately, this share may not remain far below the pre-war share of 17 per cent. Germany's traditional strength in high-quality investment goods will again pay off handsomely once the investment boom in the EMEs is in full swing. Yet, for the same reasons, Germany will also be the prime choice for emigrants from the EMEs. As to the special ethnic groups among the potential immigrants, some 2.5 million ethnic Germans, up to half a million Jews in the Commonwealth of Independent States (CIS), and up to half a million gypsies may choose to emigrate to Germany. The ethnic Germans are least likely (and the gypsies probably most likely) to move on from Germany to other EC countries.

Many EMEs are roughly comparable to Germany in climate and resource endowment. Free market access for the EMEs will hurt especially those two sectors that are by far the most protected ones in Germany: agriculture (a traditional power base of the Conservatives) and the coal industry (a traditional power base of the Social Democrats).[3] Concurrent with the growing importance of an intra-industry pattern of trade with the East, the adjustment of the German economy to an intensifying division of labour with the East will become less sectorally concentrated and thus somewhat less controversial by, say, the late 1990s.

Income differentials are likely to widen in Germany, both because of an influx of semi-qualified labour from the East and because of a cheaper supply of labour-intensive goods and services from nearby. Owing to the geographic proximity of low-wage EMEs, producers of those labour-intensive goods and services (for instance small- and medium-scale construction) which in Germany had so far been shielded from foreign competition by sheer transport costs (geographical distance to the nearest low-wage supplier) will come under considerable adjustment pressure. In turn, many West European and especially German companies may opt for a peculiar East-West division of labour with the westernmost EMEs, keeping head offices and research departments in the West (say in Wolfsburg, Munich, Berlin, or Vienna) but moving production sites to adjacent EMEs, say into the vicinity of Prague, Bratislava, Poznan, and Ljubljana.

All in all, the contrast between rich Western Europe, catching up Central Europe and poor Eastern Europe will be mirrored by a greater diversity of incomes, living conditions, and jobs — as well as habits and cultural modes — within Germany. In this respect, the new Germany will resemble the nineteenth century and inter-war Germany more than the post-war West Germany.

c. Political Consequences

Because of Germany's interest in integrating at least the westernmost EMEs closely into Western Europe, the new Germany will face tougher political choices and conflicts than the old West Germany, at least for the coming four to eight years.

3 The same holds for sunset branches like textiles and steel, although, maybe, to a lesser extent.

Immigration is likely to be a top concern for German politicians. As a consequence of its desire to pre-empt and prevent mass immigration from the East, Germany cannot but take a keener interest in East European affairs than most other EC countries; Germany is thus likely to turn into and to remain the prime advocate of East European concerns in the EC and beyond. In order to promote political stability and economic progress in its neighbouring EMEs, Germany will favour an early accession of these countries to the EC. Yet, Germany can hardly advocate a de jure or at least de facto Eastern enlargement of the EC (or the European Economic Area, EEA) — and strive to maintain the special status of its most protected sectors at the same time. The interests of major German lobbies may thus clash with political imperatives more than used to be the case.

In the process of West European integration, West Germany has not vigorously pursued many narrow "national interests" so far; as long as Germany and Europe were divided, West Germany had few policy-relevant national interests other than close integration with her Western neighbours and close cooperation with North America anyhow. Within the EC, West Germany had been willing politically to disregard short-term concerns and to offer side-payments to other EC members in order to further the long-term goal of an ever closer integration of the EC. Now that Europe and Germany are no longer divided, the new Germany faces more immediate challenges, notably the urgent need to promote political stability and economic recovery in the EMEs. German politicians are hence likely to focus more on short-term concerns than before.

So far, European political union had been an end in itself for Germany, to some extent regardless of the policies that a unified Europe might adopt. Because of the opening of Eastern Europe, Germany has genuine national interests again; thus, even without any other conflicts about the modes of a further deepening of the EC, the degree of German enthusiasm for a political union will decline substantially. In fact, support for a political union may roughly reflect the extent to which such a union is perceived as a vehicle to promote Germany's specific national interests. In short, Germany's behaviour is likely to become more like that of France and Britain. This implies that the interests of Germany and other EC countries will clash more frequently and more markedly than before.

At present, the new Germany is more inward looking and more eastward looking than old West Germany ever was. The inward-looking attitude is little else than a short-term phenomenon; it has been largely caused by the problems of unification and it will mostly subside once these problems have been overcome. However, the reorientation towards the East, i.e. the partial reversal of the exclusive westward orientation of the old West Germany, will turn out to be permanent. The proximity to Eastern Europe's EMEs — and thus the exposure to their problems and prospects — leaves Germany little choice in this respect.

By the late 1990s, i.e. once the most pressing problems in eastern Germany and the westernmost EMEs have been overcome, the situation will become far more favourable for Germany — and the EC — again. The potential conflicts of interest outlined above will ease; the need to support eastern Germany will diminish and the tax base is likely to grow, not least thanks to the economic growth induced by the economic integration between Western and Eastern Europe. This may recreate leeway to defuse intra-German and intra-EC conflicts with cash. Yet, given Germany's soaring public debt, this leeway will still be smaller than it used to be for old West Germany.

In the last analysis, the political choice that the opening of Eastern Europe demands from France is tougher than the challenges that Germany faces. France is wary of the greater weight that German unification and the opening of Eastern Europe has already given to Germany. Whereas Germany cannot but strive to draw its East European neighbours closer towards the Western Europe to which Germany belongs, France needs to rethink and probably redefine the basic tenets of its foreign policy.

On the one hand, France may continue to oppose an eastern enlargement of the EC; for this purpose, France may form a coalition with other Mediterranean EC members who are reluctant to endorse an Eastern enlargement for fear of new competitors and for fear of a diversion of EC funds towards the poorer and, thus, more deserving East Europeans. In this case, however, France would leave the EMEs little choice other than to look to Germany for political support. The alternative would be a more active French "Ostpolitik": in order to counteract a perceived German influence over the EMEs, France may just as well try to act as the major advocate of EME interests in the EC itself. In this case, France would have to clear the way for an early enlargement of the EC and risk internal conflicts (for instance with its farmers) as well as conflicts with other Mediterranean countries. And in a substantially enlarged EC, the traditional French approach to West European integration (harmonization of economic and social policies, a pivotal political role for France) would no longer be tenable.

2. Migration Pressures

a. The European Perspective

In the wake of the geopolitical events in Eastern Europe and the former Soviet Union, a rising tide of immigration is exerting mounting pressure on the member states of the EC in general and on Germany in particular. Furthermore, high fertility rates, political turmoil, and grim economic perspectives on the southern rim of the Mediterranean fuelled the process of — very often clandestine — immigration into the southern core of the EC. An estimated one million foreigners from non-European bordering countries live illegally in former migration countries, such as Italy, Spain, and Greece. Net immigration into the EC may have exceeded 0.3 per cent of the population in recent years. During the 1990s, this will probably be the bottom-line of immigration rather than an exceptionally high level.

The current and next decade's international migration will be more supply based than it used to be 20 and 30 years ago, at the heyday of "guestworker" recruitment, with its organized and demand-driven acquisition of foreign labour. Extraordinarily strong pressures for emigration exist in Eastern Europe, the CIS, Turkey, and North Africa. The prospects for immigration pressures from the East and from the South differ mainly in their expected persistence over time and in the expected countries of destination. At the European level, the Mediterranean countries will — in rough terms — be subject to South-North migration, whereas Germany will bear the brunt of East-West migration and of pressures originating from Turkey.

It is important to note that, so far, the massive immigration deluge from Eastern Europe and the CIS which had been predicted by a great number of analysts has not yet materialized. The often mentioned nightmare of up to 40 million people suddenly besieging the immigration-averse "Fortress Europe" seems to have more of a mirage than of a realistic scenario. Whether it will happen at all depends on the further evolution of the transformation process and on the economic, political, social, and ethnical disruptions that these processes may entail. Migrants from Eastern Europe into the EC can be classified into three major categories, namely (i) special ethnic minorities such as ethnic Germans from the CIS, Jews from the CIS, and gypsies from the CSFR and South-East Europe; (ii) refugees from political turmoil and civil war; and (iii) migrants from dominant ethnic groups (or non-oppressed minorities) who yearn for a better living in the West. Unless the disintegration of the CIS — and possibly also of the Russian Federation — turns into civil war, the first group of migrants will be the most important one.

The major link between the economic situation in the EMEs and migration will be indirect. Ethnic antagonism will be particularly pronounced in those countries in which the transformation crisis is deep and long: a severe transformation crisis may increase the pressure on the special ethnic groups to move west; it may also nurture political instability, and thus swell the number of political refugees.

Despite the huge gap in living standards, the number of East Europeans who will try hard to settle permanently in Western Europe for purely economic reasons is likely to be small. Since the transformation process has seriously begun in the EMEs, the most entrepreneurial and most mobile segments of the population have ample opportunities to become rich, and enjoy their incomes in the EMEs themselves. This distinguishes East-West migration from South-North migration (for instance the migration from the Maghreb to Southern Europe). Instead, many Central Europeans will want to commute to adjacent Western countries (weekly or even daily in the border regions) or look for seasonal jobs in Western Europe. The latter would mean a return to a pre-World War I pattern of seasonal labour movements. Of course, ethnic neighbourhoods may gradually evolve in major West European cities (for instance Poles in Berlin; Czechs and Slovaks in Munich and Vienna; Croats and Slovenes in Trieste); once such neighbourhoods are well established, the threshold for further migration will be lower. The number of permanent migrants may then increase faster than initially.

The movement across the Mediterranean is demographically more powerful than the one across the Oder-Neisse line. For the countries on the southern shores the economic factors are reinforcing the demography — the fertility rates in the southern shore of the Mediterranean exceed those of Western Europe by a factor of two (e.g. Turkey) to three (e.g. Algeria). And there is no systemic change in sight that could improve the economic prospects in the long run. Hence, whereas immigration from the East will rise — perhaps even substantially so — throughout the next decade or so and taper off thereafter, there will be mounting and persisting pressure of migration from the south until far into the next millenium.

There has been a marked shift in the character of the immigration process in Europe throughout the 1980s which reflects the rather defensive attitude of European countries towards immigration: the refugee door has become an increasingly important entry gate into the EC from the outside; the number of asylum-seekers rose from 14,000 in 1973 to 71,000 in 1983 and to 575,000 in 1991.[4] There is little doubt that the asylum system throughout Europe is under strain from the constant growth in the numbers seeking asylum and the rapidly rising costs of processing claims. The estimated costs of processing the asylum applications and providing care to the applicants amount to about US$ 7 billion in Europe in 1991. Less than 10 per cent of the applications — and at a declining rate — are granted asylum. Nevertheless, it is estimated that 75 per cent of applicants who undergo the full procedure after screening at ports of entry stay in the country when the procedure has been completed and whatever its outcome.

To be sure, the share of the non-EC population in the EC is far from threatening: it does not exceed 2.5 per cent of the common market population; the EC foreigners amount to about 1.5 per cent. Nevertheless, a general "the boat is full" attitude is spreading in ever-widening circles throughout Europe. There are strong signs that one important dimension of the future context of migrant arrival in Western Europe will be resurgent racism, as currently seen in the Vlaamse Blok in Belgium, in the resurgence of neo-Nazism and right-wing parties or pressure groups in Germany, Austria and Switzerland, in Le Pen's Front National in France and the Movimento Sociale Italiano (MSI) and the Lega Lombarde in Italy. Whilst the immediate objective of these groupings is only to discontinue immigration, their existence is likely to have profound repercussions on living conditions of ethnic minority communities, leading to further restrictions to assimilation and, as a counterreaction, a rising group identity in these communities. This may endanger political and social peace not only from the perspective of native citizens trying to preserve their "rights" at all cost but also from that of the foreign population left at the fringes trying to avoid to have a life of complete and prolonged emargination. There is hardly any hope in the short run for a more relaxed attitude at the dawn of important elections in various EC member countries up to the mid-1990s (e.g. in France and in Germany).[5]

---

4 Jonas Widgren, Movements of Refugees and Asylum-Seekers: Recent Trends in a Comparative Perspective. International Conference on Migration, Rome, 13–15 March 1991, mimeo.

5 However, one should not attribute the rumblings on the right wing only to xenophobia due to immigration. There may also be rising anxieties about loosing national, regional and even local identity in the process of European integration, sustaining the renaissance of patriotic sentiment that is mingling with nationalistic endeavours.

Although immigration is hardly taken as a positive supply-shock nowadays, there are good reasons not to extrapolate the current xenophobic sentiment into the long run. It will become increasingly evident that demography could — in one decade or two — put a brake on growth in the Western European economy. Immigration may to some extent represent a temporary "fountain of youth" as most European populations are ageing, with the German population aging most rapidly of all. The Western European population will likely start to decline after the year 2010 if no further immigration occurs. Labour markets scarcities would build up even earlier, strengthening demand-pull factor in favour of immigration. Furthermore, immigration could postpone the imminent problems of the pension systems (see Section II.2 below).

b. The German Perspective

Despite official denials, West Germany has been an immigration country ever since the beginning of the 1950s and even in a historical perspective. The relative size of the inflow of migrants is comparable to the immigration into the United States at the beginning of this century. The leitmotiv of German guestworker policy, the rotation principle, which means economically that foreign workers figure as a "buffer stock" to alleviate temporary labour shortages, has proven to be a mirage, in particular since the (Europe-wide) recruitment stop for non-EC labour in 1973: guestworkers have come to stay. In 1987, about 60 per cent of the foreign population was already living in West Germany for more than ten years. This is a kind of paradox: the largest part of the "guestworker population" is staying in a close to permanent immigration situation in a non-immigration country where the jus sanguinis does in general not allow them to become German even if they married a native German citizen; furthermore, naturalization is very costly.

Immigration into Germany has in the 1980s been fed from four sources (Table 1): (i) inflow from the former GDR ("Übersiedler"); (ii) inflow of ethnic Germans from the former socialist countries ("Aussiedler"); (iii) asylum seekers; and (iv) conventional immigrants (e.g. in the course of family reunification; on the basis of work permits; from EC countries). In 1989, there was a net flow of immigration of roughly one million people (1.6 per cent of total population in West Germany), in 1990 of about 900,000. Two thirds of the net immigration flows in 1989 and 1990 — being ethnic Germans — were entitled to receive a German passport. Recently, the number of the "Aussiedler" declined considerably from about 400,000 (1990) to 220,000 (1991). This decline was mainly due to a more cumbersome queuing procedure and special efforts to give the ethnic Germans an incentive to stay in the countries where lived so far. Currently, there is a backlog of about 500,000 applications of "Aussiedler" to settle in Germany. To be sure, most of the "Aussiedler" are as alien to Germany as the immigrating non-German population, with hardly any command of the German language and no up-to-date knowledge about the country and the society itself. To a large extent, the "Aussiedler" are also regarded as foreigners by the incumbent German population, and not welcomed with more enthusiasm than non-Germans.

The inflow of foreigners (gross as well as net) has been subject to strong cyclical fluctuations, in line with the pattern of the German business cycle. Recently, there has been a surge of asylum applications — from 57,000 in 1987 to 438,000 in 1992. For these applications, the approval rate declined substantially from an already low 11 per cent in 1987 further down to 6 per cent in 1991. Many of those who have not been granted asylum according to the German asylum law cannot be returned because of the 1951 Geneva UN Convention and on humanitarian or other grounds; this has been the case for about 57 per cent of disapproved applicants in 1989. Returning disapproved asylum applicants to their home countries is a cumbersome process, not least because it requires acceptance of

Table 1 — Migration across German[a] Borders, 1980–1991 (1000)

	Immigration						Outmigration			Net immigration			Population	
	gross inflows													
	total	Germans			foreigners		total	Germans	foreigners	total	Germans	foreigners	total	foreigners[b]
		total	Aussiedler	Übersiedler	total	asylum seekers								
1980	753.4	122.0	52.1	12.0	631.4	107.8	441.5	55.7	385.8	311.9	66.3	245.6	61538	4313
1981	625.1	124.0	69.5	14.5	501.1	49.4	472.7	57.2	415.5	152.4	66.8	85.6	61663	4459
1982	420.8	108.1	48.2	12.8	312.7	37.4	492.7	59.4	433.3	–71.9	48.7	–120.6	61596	4444
1983	372.0	98.8	37.9	10.7	273.2	19.7	487.3	62.4	424.9	–115.3	36.4	–151.7	61383	4291
1984	457.1	126.0	36.5	38.7	331.1	35.3	602.8	57.7	545.1	–145.7	68.3	–214.0	61126	4027
1985	509.3	111.1	31.0	26.3	398.2	73.8	419.9	53.2	366.7	89.4	57.9	31.5	60975	4010
1986	596.7	118.4	42.8	26.2	478.3	99.7	400.8	53.0	347.8	195.9	65.4	130.5	61010	4124
1987	614.6	142.3	78.5	19.0	472.3	57.4	394.6	60.6	334.0	220.0	81.7	138.3	61077	4146
1988	903.9	255.4	202.7	39.8	648.5	103.1	418.3	59.2	359.1	485.6	196.2	289.4	61450	4489
1989	1522.2	769.6	377.1	343.9	752.6	121.3	545.0	106.7	438.3	977.2	662.9	314.3	62063	4846
1990	na	na	397.1	238.4[c]	na	193.1	na	na	na	na	na	na	63253	5242
1991	na	na	222.0	·	na	256.1	na	na	na	na	na	na	64074	5582

[a]1980–1989 West Germany, thereafter including the former GDR. — [b]Own estimates. — [c]Until June 1990. — na = not available.

Source: Statistisches Bundesamt: Fachserie 1: Gebiet und Bevölkerung, Reihe 1: Bevölkerung und Erwerbstätigkeit. Stuttgart, various issues; Statistisches Jahrbuch. Stuttgart, various issues.

these countries. Only about 3 per cent of asylum seekers are actually returned. In 1991, roughly one million refugees was staying in Germany.[6]

The surge of asylum seekers is perceived as a severe matter of concern for the public at large, in particular because the processing of applications and providing accommodation is costly: the federal government estimates that these costs amounted to DM 6.4 billion for the federal, state and municipal purse in 1991 — as compared, for example, with a public budget on development aid of DM 9.3 billion in 1989. Per asylum applicant the costs add up to about 15,000 DM annually.[7] Since July 1991, asylum seekers are entitled to work, but only under some quite restrictive conditions such as the lack of an adequate German or EC citizen to fill the particular vacancy in question, and a highly constrained regional mobility. To what extent this option has been used and what its impact on the welfare bill has been is as yet unknown.

The widespread perception that the liberal asylum law is abused by "arbitrage" or "economic" asylum seekers whose main objective is to exploit the generous German welfare system has harnessed xenophobic tendencies, of which the violence in Hoyerswerda, Rostock and Mölln was the most conspicuous cases in point, widely echoed in the national and international press. Skinhead attacks, actions of outright hooliganism and vandalism gave rise to the concern of a revival of Nazism in Germany. However, as many observers and analysts have recognized, xenophobia is neither a specific German nor a new phenomenon but a storm that is ravaging the whole of Europe. With respect to the new German states it has to be acknowledged that

- the citizens of the former GDR did not have experience with foreigners; foreign workers, rare anyway and brought in on the basis of state decree, were living apart and were envied by the general public because of presumed privileges, such as the possibility to travel back to their countries of origin;
- a vacuum did arise in the transition from "cradle-to-grave" governance by an oppressive authoritarian regime to individual decision making in a liberal environment;
- the economic and social disruptions in the wake of the transformation process of the bankrupt socialist economy brought about an abrupt exposure to West German lifestyle and fierce competition; and
- there are problems with self-confidence and mutual trust due to the dependence on West German transfers and the heritage of the secret police supervision that even cut across personal relations.

All these factors spur the diffuse right-wing obsessions in fringe groups. For the time being, however, there is no articulate political leadership around which these marginal groups could cluster and be given specific and more powerful orientation toward fascist and nationalist goals on broad basis. In that sense, these are signs of protest that most probably will peter out with rising prosperity, or simply with time. In any event, the xenophobic sentiments do hardly justify a general distrust in the stability and reliability of the German democratic institutions.

The prospects for further immigration into Germany depend to a large extent upon whether and how the transformation process in the former socialist countries will gather momentum, economically, politically and socially (see Section I.1 above). A backlash with an implosion of high-flying expectations, nationality rifts and riots would, for sure, harness the pressures on the German borders.

As to the ethnic Germans, there are still up to three million people of German origin in the East, two million in the CIS alone. Russia and the Ukraine seem ready to devote land, and — at least some — autonomy for the settlement of the German descendants in their countries. These prospects are

6 See Klaus-J. Bade, Deutsche im Ausland — Fremde in Deutschland. Munich 1992.

7 Bundesministerium des Innern, Press Release, Bonn, March 1992.

anything but assured and there are signs that the ethnic Germans are determined to settle in Germany and nowhere else. To be sure, the most recent wave of immigration of ethnic Germans was integrated relatively easily into the German labour market. The expected slowdown in economic activity for the near future may make the road bumpier but there are no reasons to assume that the difficulties of integration will rise dramatically. Initial mismatches of skills, occupational and sectoral experiences could be overcome by retraining. The business community broadly regards the newcomers as a welcome flexible addition to the labour force. The pleasure of being "out of there" and the expectation of a safer haven for themselves and their children is conducive to adjust quickly to the new environment.

In the longer run, the "homines migrantes" will mainly come from Turkey, a country which has traditionally close links to Germany. The Turkish labour potential, measured as the size of the population in the 15–64 age bracket, is rising from 34 million in 1991 to 42 million people in 2000.[8]

Not only Germany but Europe as a whole will be unable to effectively control the entry of low-skilled and illegal immigrants. Hence, the informal sector will expand, with more competition between immigrants leading to an enhanced labour market segmentation, but also to a more de-facto deregulation of labour markets. Nevertheless, even in those cases where immigrants will be living on the fringe, they will be regarded as being better off than if they had stayed at home, which will sustain the momentum of immigration.

c. Some Policy Issues

In the coming years, the discussions about the pros and cons of immigration will flourish. At present, the empirical assessment is still rather controversial, with opponents dominating the political arena and the general public discussion; it seems to be mainstream thinking that immigrants take more from the public purse than they add to it. However, recent research shows that foreigners have been an asset for the German public coffers not only in the last four decades, but also in the most recent past, although the positive contribution of immigration might diminish in the future as the labour force participation rate of foreigners is now close to the one of Germans, and their average unemployment rate even higher; but they still have a lower average income than Germans and — most important of all — they have a "better" age structure with a higher share of young people, which helps to widen future financial bottlenecks of the social security system (see Section II.2 below).

As to further pros, immigration has helped easing labour market tensions and foreign workers tend to foster the upward mobility of the native work force. In addition, revealed preferences of consumers indicate their appreciation for the increased variety in the supply of services (e.g. in catering), and the somewhat more colourful cultural environment. As to cons, it is maintained that migrants take jobs away from native workers; that there is anti-social behaviour by immigrants, such as welfare dependency or crime, unwillingness to integrate; tensions in housing markets would be harnessed; bottlenecks in urban infrastructure worsen; educational standards might suffer; the stability of the labour market in general and wages in particular is endangered. Strain on the public purse that discourages appeasing hand-outs to native citizens spurs envy, exclusion and marginalization of refugees in particular and foreigners in general. Immigration is thus perceived as a negative-sum game and, hence, further immigration seems to be unsustainable. It is important to note, however, that in many instances the perceived costs of immigration are not directly caused — though possibly accentuated — by immigration itself. Many of the time-honoured and broadly accepted domestic policies in these areas are by themselves largely inefficient or even ineffective. In any event, they represent a major drain on taxpayers' money, and would deserve a profound reconsideration anyway. Immigration pressures may give additional reason to rethink housing policies, instead of taking recourse to closing the borders for the inflow of people: a deregulation of the housing market which may spur a regional decon-

8 United Nation, World Population Prospects. New York 1991.

centration of economic activity would likewise be a complementary policy response which could be advocated on its own merits. And it is highly questionable whether every part of labour market regulation and the pay structure is appropriate and sustainable anyway. In all these instances, potential migration could be just another incentive for pursuing the appropriate kind of economic policies.

Even proponents who perceive immigration as a positive-sum game, acknowledge that too much of a good thing at a time may finally turn it into a bad. A sudden "migration of nations" would probably exceed the absorptive capacity of the member countries of the EC. Hence, there is a need for an immigration policy. In that, it is necessary (i) to disentangle humanitarian refugee policy from immigration policy, which is part of economic policy in general; and (ii) to clearly define criteria for taking in additional immigrants.

In both instances — asylum policy and immigration policy — community-wide rules are called for. The free movement of people across intra-EC borders implies that effective control of entry is — if at all — possible only at the external borders. Hence, a common set of rules has to be applied. With respect to asylum law, Germany is adjusting to the more restrictive provisions applied in all other member countries.

In the four decades of its separate existence, West Germany had twice experienced a rise of right-wing sentiment and right-wing parties: in the late 1960s and the late 1980s. In both instances, public anxiety about an above-average inflow of immigrants contributed to the success of the right-wing parties. To counteract the hazard of the current new surge in public support for the extreme right, German politicians are likely to temporarily adopt a far more restrictive stance on immigration than they had so far. A more liberal immigration policy could aim at establishing immigration permits to persons from selected countries. These immigration certificates could be sold or auctioned by the state to persons who wish to immigrate. The price to be paid for a certificate is the entry fee to join the club that offers the public goods. (It has to be kept in mind that even today's immigrants pay a fee of a considerable amount — fees of US$ 500 up to US$ 5000 have been reported to sometimes mafia-like organizations.)

Clearly, immigration policy is not sufficient in itself to reduce the pressure for migration in the source countries. The Community will have to alleviate the pressure by complying with the rules of the open, multilateral trading system, including reduced support for agriculture and as yet "sensitive" manufacturing areas in which these countries could exploit a huge employment potential. To bemoan the emerging threat of immigration and, at the same time, sustain a protectionist policy stance is a fundamentally inconsistent position.

3. The Multilateral Trading System

a. Rising Tide of Protectionism

The international economic environment of European firms is characterized by an erosion of GATT principles. Beginning in the 1980s, hidden and sometimes even open breaches of GATT regulations have developed into a conflict between multilateralism and regionalism as guiding principles of the international trading system.[9] Partly as a reaction to European integration, the US have launched the North American Free Trade Association (NAFTA) with Canada and Mexico, and several other Latin American countries have entered negotiations about President Bush's Enterprise of the Americas' Initiative. The US has, furthermore, intensified their use of antidumping procedures and the 301 regulation while increasing the pressure on Japan through the Strategic Impediments Initiative to accept more US exports. Likewise, regionalism has made headway in the Asia-Pacific region. The Malaysian

9 Bhagwati, Jagdish N., The World Trading System at Risk. New York 1991.

proposal to form an East Asian economic caucus and the decision of ASEAN countries to establish a free trade area were first indications in this direction.

Which way the pendulum will swing in the future depends to a large extent on the outcome of the Uruguay Round, and in particular on whether the US and the EC can forge a compromise on the future shape of the EC's Common Agricultural Policy. Such a compromise is the precondition for success in the other negotiating groups that includes a reintroduction of GATT rules on trade in textiles and clothing as well as extensions of GATT rules to services, trade-related investment measures and intellectual property rights. After many fruitless attempts at different political levels the agricultural issue is now on the agenda of top politicians indicating that the search for a solution is finally receiving the attention it deserves. However, because there is a new US administration and because of the failure to settle bilateral US–EC trade policy disputes, the Uruguay Round could not be successfully concluded before the expiry of the "fast track negotiating mandate" given by the US President. The new US administration has indicated that it will ask the US Congress for an extension of this mandate and that it will be seeking modifications of preliminary Uruguay Round results. This will substantially delay the final conclusion of the Round.

Even assuming a successful conclusion of the Uruguay Round, the multilateral trading system will continue to suffer from weaknesses inherent in GATT rules and regulations. In particular, the provision for special and differential treatment of some member countries and the lack of effective sanctions against violations of trade rules weaken the principle of multilateralism.[10] The conflict between MFN and preferential treatment has recently been sharpened by the trading arrangements with the Central and Eastern European economies in transition. The arrangements add a new dimension to the hierarchy of EC preferences accorded to groups of non-member countries, and lessen the incentives for these countries to support the GATT system (as could be observed in the case of many developing countries enjoying special preferences).

b. The German Trade Policy Stance

The German government has traditionally been committed to an open international trading environment and MFN treatment. Within EC institutions, the government has used its influence in favour of a liberal common external trade policy and against the emergence of a "fortress Europe". Domestically, non-tariff barriers were removed for a wide range of manufactures or simply not enforced. There are no indications that this basic trade policy stance of the German government has changed or will change in the near future. The rather passive role Germany has played in the Uruguay Round so far rather reflects a conflict of priorities. The government has been a major force pushing European Economic integration and did not want to jeopardize this process by insisting on a substantial reduction of agricultural export subsidies which would hit hard particularly the French farmers.

At the Maastricht Summit, important stumbling blocs on the road to European integration were removed, and a process leading to an economic and monetary union was set in motion. Having achieved this, the German government appears now to be determined to devote more attention to a successful conclusion of the Uruguay Round. This is evident from the German government's official endorsement of the preliminary results achieved by end-1992 in negotiations on the agricultural issue between the EC Commission and the Bush administration. Given the fact that trade policies in the 1990s are deeply intertwined with other issues such as security policies, burden-sharing in restructuring Eastern European economies, and financing international compensation funds for protecting the environment, there is strong pressure towards a cooperative game. More practically, the costs of German unification and the high financial transfers to Eastern European countries require a sound balance of payments position which — in an extremely export-oriented economy like Germany — would be seriously en-

[10] Langhammer, Rolf J., Nachsitzen in der Uruguay Runde. Institut für Weltwirtschaft, Kiel Discussion Papers, 170, July 1991.

dangered by a resurgence of protectionism in response to a failure of the Uruguay Round. Nor can the new markets emerging in Eastern Europe be a substitute for an open international trading environment: for quite a while, demand from Eastern Europe will remain limited and volatile due to the shaky foreign exchange position of these countries.

However, the government's view does not necessarily reflect a consensus in society. Obviously, the well-organized agricultural lobby opposes any trade agreement which would require further adjustment in the agricultural sector. Industrial lobby groups have generally been supportive to liberal trade policies, but with the mounting pressure of especially Japanese competition important branches of manufacturing such as the motor industry and electronics begin to have second thoughts. Leading representatives of the motor industry have — less vigorously than in France or Italy — welcomed the restrictions on Japanese car imports into the Common Market while producers of electronic equipment, in particular chips and semiconductors, are afraid of losing out to Japanese suppliers. They paint a picture of Germany falling behind technologically because Japan is feared to control key technologies on which German capital goods industries and many consumer goods industries depend. This envisaged dependence on imported technology is increasingly used as an argument for strategic trade policies: domestic production of key technologies has to be protected in order to secure the future competitiveness of the German economy.[11] In general, however, demands for an "industrial policy" approach have been much less vigorous than in the US, and, if anything, the German government is rather likely to satisfy such demands by subsidies than by demanding more restrictive EC trade policies (on these issues in detail, see Section I.4 below).

c. Perspectives

First, the empirical evidence suggests a number of trends which will continue well into the 1990s and possibly beyond:

- The uncertainty surrounding the international trading system will lead more countries to join regional trading arrangements as a safeguard against a breakdown of the GATT. Only a convincing conclusion of the Uruguay Round may be able to stem this tide.
- Actual and perceived protectionist threats have encouraged a substantial redirection of foreign investment flows to the EC and the NAFTA. This means that the attention of policy makers will increasingly focus on trade-related investment measures since traditional trade policies can no longer protect domestic producers against foreign competition. Such measures include those which prevent circumvention of existing antidumping duties.
- The EC agreements with Eastern European countries have started a process of market integration which will unfold throughout the 1990s. It will be more far-reaching than other similar integration schemes, e.g. with developing countries, and in its final stage it will create a unique regional trading area. In order to maintain access to this large market, non-European countries have a strong incentive to demand a liberal trade policy stance from the EC.
- The number of developing countries pursuing liberal trade policies is increasing, even in debt-ridden Latin America. These countries have a growing interest in securing the multilateral trading system, and will join the ranks of those fighting for a strengthening of the GATT.

In addition, there are a number of new challenges which are likely to top the agenda of future GATT negotiations. One is related to the growing ecological concerns which lead countries to establish ecological standards which could be used as a new protectionist device, particularly against sup-

[11] Seitz, Konrad, Die japanisch-amerikanische Herausforderung — Deutschlands Hochtechnologie-Industrien kämpfen ums Überleben. Stuttgart 1991.

pliers from Eastern European and developing countries. To prevent this, an extension of the GATT framework is desirable.

Second, there is evidence that within Europe the challenges of globalization of production and international networking have encouraged restrictive business practices. The private concerted actions escape GATT monitoring and surveillance which is tilted toward national policy actions. These private activities may counteract the impact of national trade and competition policies, and may result in less intensive international competition. Rather than to retaliate such development by industrial policies or excessive antidumping actions, international competition rules could provide a more efficient instrument to secure the effectiveness of the international trading system. Yet, the disenchanting experiences with national competition policies do not lend much support to optimism that an international competition policy will perform better. The EC example of the Community-wide merger control suggests a clash between those using competition policies as a surrogate for industrial policies and those seeing them as a (second-best) tool for dismantling restrictive business practices. It is very likely that such a clash would also impede the enforcement of international competition policies.

Third, liberalizing trade in services will crucially depend on the expected impact on labour migration. Where this impact is likely to be large, as in construction and some consumer services, Germany will hardly be better prepared to allow migrant workers in than the rest of the Community. This has been witnessed by the restrictive stance taken by the Community in the association agreements with the three Central and East European countries. Although Germany agreed to negotiate small quotas for guest workers on a bilateral basis, this concession has not gone much further than that of the Community as a whole. In each EC member state including Germany a strong coalition of employers and employees in labour-intensive service industries successfully uses arguments such as "social dumping", "cultural homogeneity", and the danger of job losses to prevent import liberalization for labour-intensive services.

Fourth, the EC and EFTA will become the preferred export markets of all Eastern European countries including the CIS member states. Their future export supply could easily become confined to land-intensive goods such as agricultural products if access to financial funds for modernizing the industrial capital stock will be insufficient. Under such circumstances the EC could be exposed to political pressure to open the agricultural market much more rapidly than initially targeted in order to discourage the inflow of surplus labour from Eastern Europe. It cannot be excluded that the Community would then shift parts of the adjustment burden to non-EC agricultural exporters (like Latin American suppliers) by continuing to discriminate against their agricultural exports to the EC.

4. Industrial Policy

a. The Recent Controversy

Industrial policy is likely to be one of the most controversial topics of the future discussion on economic policy in major industrialized countries. Industry, government and the public are increasingly worried about the export success of Japanese companies in high-tech markets and the corresponding decline in the competitiveness of domestic firms. Some observers even predict that Germany and other European countries might eventually step down to a technological colony of Japanese industrial giants.

There is little doubt that technical leadership has shifted to Japan in many areas, but there are two opposing views about the causes and appropriate cures:

— The traditional view, which is held by major parts of the present government in Germany, by most employer associations and by mainstream economists, basically explains the weak European market position by an inferior internal efficiency of firms, by dispersed national markets, and by protectionist policies in Europe that are hampering flexible adjustment of domestic firms to international competition. The recommended remedy is the opening of markets and the strengthening of the principles of free trade.

— The alternative view, which originates from traditional industrial policy concepts of the unions and the Social Democrats and which is backed by some recent developments in economic theory, mainly ascribes the technological advance of Japan to unfair import deterrence in Japanese high-tech markets, and to strategic long-term planning of MITI. Hence, it is urged that Germany (or perhaps the EC) should have its own MITI and that multilateral trade should be replaced by bilateralism.

The second view increasingly gains ground in the public and also in those industries that are suffering from Japanese import competition. Nevertheless, it should be kept in mind that the term "industrial policy" still has a rather negative flavour for most participants in the German political debate. For most of them it is associated with distortive government interventions and even with more or less legal forms of reacting to lobbying activities at the expense of consumers and taxpayers. At times, some politicians even pretend that there is no industrial policy at all in Germany. They prefer the term "structural policy", which is less reminiscent of intervention and also covers the broad field of regional policy.[12]

The debate was heavily stimulated by the publication of the above mentioned book on the alleged Japanese-American challenge to German industry.[13] The author, Konrad Seitz, identifies an alarming fall-back of German companies in five major technology fields that are assumed to be the most important ones for the future, namely information technology, biotechnology, new materials, new energy sources, and space technology. He concludes that a coordinated and powerful attempt of all social groups — meaning in particular the government, employers and unions — is needed in order to counter the secular decline in the technological position of Germany.

Several of these contentions are heavily disputed in the public; many critics are pointing out that Seitz strongly exaggerates the technological decline of the German economy. German firms have always been strongest in "medium" research-intensive industries and not in most advanced high-tech industries. Moreover, there are doubts about the substance of the idea of one-sided economic dependence in an open world economy which is based on the principle of voluntary exchange. Finally, the reasons behind the success story of Japan are far from clear. It is still an unsettled issue whether Japanese companies are really enjoying the advantages of an unlevel playing field or are simply better players.

Apart from these considerations, the most striking feature of the recent debate is the affirmative resonance of the Seitz propositions in some parts of German industry. In the past, German employer organizations repeatedly and unequivocally stated that active industrial policy would be a first step towards central planning, and would erode the basic principles of a market economy. At present, the front line against industrial policy seems to be weakening, as several former free traders feel increasingly attracted by the ideas of strategic industrial policy. It can be expected that the ongoing shift in attitude of German industry towards industrial policy will eventually result in a corresponding shift in government policy sooner or later — sooner if the Social Democrats take over, later if the Christian Democrats and Liberals stay in power.

[12] Perhaps, this uneasiness of German politicians with industrial policy at least partly explains the German resistance to the inclusion of Artikel 130 into the Maastricht Treaty on Political Union, that gives more competence in industrial policy to the Commission of the EC.

[13] See footnote 11 above.

b. The Record of Interventions

The official guidelines of industrial policy in Germany are the "principles of sectoral economic policy" that were resolved by the federal government already in 1968. According to these principles, government interventions should support and not impede structural adjustment, and protective measures should be granted only temporarily. In the past, however, industrial policy in Germany has mainly reacted to adjustment problems of ailing industries. Its central features were the provision of internal protection by subsidies, above all to agriculture, mining, steel-mills and shipyards, and the provision of external protection by trade barriers, mainly to textiles and clothing and to the food industry (see Table 2).[14]

Table 2 — Subsidies in West Germany, 1980–1990

	Subsidies		Subsidies per employed person	
	million DM		DM	
	1980	1990	1980	1990
Total business enterprise sector[a]	78976	105910	3569	4632
Agriculture	16792	24300	11969	25286
Mining	6257	11455	27204	60289
Manufacturing	11608	16535	1276	1849
Iron and steel	671	565	2158	2811[b]
Shipbuilding	688	470	11862	13429[b]
Aerospace	588	1325	10889	19485[b]
Office equipment and computer	138	225	1816	2250[b]
Transport, communication and trade	22100	26450	4392	4976
Railways	12577	14285	35730	54316[b]
Service industries	15628	18130	3937	3442
Not elsewhere specified	1722	2930	x	x
Subsidies as percentage of gross value added in business enterprises[a]	6.9	5.8	x	x

[a]Excluding real estate. — [b]1989.

Source: Astrid Rosenschon, "Subventionen in den alten Bundesländern". Die Weltwirtschaft, Vol. 1, 1991, pp. 76–90; Statistisches Bundesamt, Fachserie 18: Volkswirtschaftliche Gesamtrechnungen, Reihe 1: Konten und Standardtabellen. Stuttgart 1992.

In accordance with the principles of sectoral economic policy most public support programmes were in fact intended to be only temporary, but they were usually prolonged when sectoral adjustment problems turned out to be persistent. For instance, the first programme of government assistance to shipbuilding was launched in 1962; but instead of fading out after some years it was replaced by subsequent programmes again and again. In the aftermath of 1973, government interventions were significantly intensified. In 1982, when the centre-left coalition was replaced by the centre-right coalition, the government seemed to be determined to cut back subsidies substantially. But these attempts were not very successful and the share of subsidies in value added was only moderately reduced. Since 1991, the share is increasing again due to the massive subsidization of eastern German industry.

Industrial policy did not prevent the gradual decline of ailing industries, but it is likely to have slowed down the pace of structural adjustment and significantly contributed to conserving resource-

[14] The regular reports of the government on subsidization are rather incomplete. Therefore, the Kiel Institute of World Economics has established its own data set on subsidies in Germany. The table is based on these estimates.

intensive and capital-intensive low-tech industries. There are only two exceptions to this general rule, namely research and technology policy and the Airbus programme. In these two areas, the government explicitly aims at promoting high-tech industries and thus speeding up structural adjustment. However, the figures presented in Table 2 clearly show that government support to high-tech industries is still only a small fraction of the total amount of subsidies paid.

c. Future Prospects

Despite the failure to cut back subsidies in the 1980s, it can reasonably be predicted that government support to western German industry will be reduced in the course of the 1990s. The reason is that the reconstruction of the eastern German economy will put such a high burden on federal budgets that the current level of subsidization in western Germany can no longer be afforded. To be sure, budgetary and political pressures will not lead to a decline in the total level of subsidization, but rather to a shift of subsidies from West to East, mostly subsidies to support senile industries left over from socialist times (on this matter, see Section II.1 below). Hence, it is unlikely that there will be much scope for strategically motivated support of high-tech industries in Germany as a whole in the years to come.[15]

These rather cheerless prospects for the success of industrial policy are widely recognized and quite well understood in Germany. Nevertheless, lobbying groups from high-tech industries — especially from microelectronics — will probably press for more protection against Japanese companies, either by sectoral subsidies or by erecting non-tariff trade barriers such as Euro-specific norms and standards or restrictive public procurement. German industry seems to be rather indifferent on whether this protection will be granted by national or by EC authorities. If the German government bends down to these political pressures, the result could be a certain reconciliation in the design of future EC politics between the traditional German position and the more *étatiste* Franco-Italian standpoint on the role of state interventions. The outcome could be a division of labour in industrial policy between the German government — concentrating on programmes for mitigating structural unemployment — and the Commission of the EC focusing on the support of advanced technologies and strategic industries.

There is little doubt that "defensive" attempts to preserve obsolete capacities in old industries will not prevent their decline and will eventually reduce the adjustment flexibility of the whole economy. But it must also be doubted that strategic industrial policy will be successful. Government programmes that are intended to improve the international competitiveness of national (or European) firms are most likely to fail in a competitive environment with multinational firms. The ever increasing potential for globalization of markets and internationalization of production makes national policy programmes targeted at national firms look more and more misplaced since protectionist barriers can be bypassed by foreign direct investment.[16]

Even restrictive local content requirements are promising only temporary relief, as many Japanese subsidiaries in Europe (especially in the motorcar industry) have demonstrated that they are able to cope rather easily with such restrictions. Moreover, it is becoming ever more difficult to draw a meaningful border-line between foreign-controlled firms and indigenous European firms. After all, according to Article 58 of EEC treaty, European companies and foreign-based companies that are producing in the EC area are to be treated on equal terms; under these circumstances, it will prove very hard to secure European-based firms a competitive edge by providing internal or external protection to these firms exclusively.

---

[15] For a detailed discussion of strategic industrial policy, see Georg Bletschacher, Henning Klodt, Strategische Handels- und Industriepolitik. Theoretische Grundlagen, Branchenanalysen und wettbewerbspolitische Implikationen. Kieler Studien, 244, Tübingen 1992.

[16] Henning Klodt, Trade Policy and Multinational Enterprises. Institut für Weltwirtschaft, Kiel Working Paper, 492, October 1991.

One reason for establishing foreign subsidiaries within the EC is probably the desire of companies from third countries to get a foot into what they perceive as "Fortress Europe". But this is only part of the story. The basic driving force behind the globalization of markets and the internationalization of production seems to be the rapid decline in information and communication costs in the past two decades. Due to this decline, which mainly resulted from technical progress in microelectronics, monitoring and supervising, production abroad has become less costly and thus more profitable than in earlier times. Replacing exports by foreign direct investment basically means replacing trade in goods by trade in information. Therefore, reduced costs of transmitting information across national borders are encouraging the shift of production sites from headquarter countries to those countries where the consumers are located.

In the past, the advocates of strategic industrial policy could probably afford to ignore the existence of foreign subsidiaries, because there were only a few of them in high-tech industries. At present, the situation is changing significantly. Direct investment by third countries within the EC is expanding much more rapidly than imports of high-tech goods. This trend will probably continue, as the decline in the costs of information and communication is expected to continue as well. Hence, the concepts of strategic industrial policy will successively erode and trade barriers will more and more look like Swiss cheese. National and EC policy-makers should be ready to accept that the principle targets of strategic industrial policy — the national champions — are steadily becoming global champions.

5. The Adjustment of Agriculture

a. Global Prospects

Malthus has been and will continue to be disproved by history. During the past decades the growth rate of agricultural production remained slightly above the rate of population growth on the global level, resulting in a moderate increase in calories available per head and day. Nevertheless, malnutrition and hunger are persistent problems in many developing countries. During the past decades these countries as a group faced a chronic food deficit, in contrast to growing surpluses in industrial countries. The main reasons are:

- a still very high rate of population growth coupled with low incomes;
- inefficient economic systems in general, with very often negative protection for the agricultural sector in particular;
- high import availability of food and depressed world market prices as a consequence of high protection for agriculture in industrial countries.

While relief with respect to the first factor is not in sight for the near future, a major change can possibly be expected for the remaining two. There is a growing awareness of the detrimental effects of high agricultural protection in industrial countries on food-exporting countries, on the non-agricultural sectors in industrialized countries, on the trade system, and on the allocation of resources in general. For the first time, liberalizing agricultural trade is on the agenda of GATT negotiations and has been given a high priority. A successful conclusion of the Uruguay Round could result in a relocation of agricultural production towards more efficient producers, which quite frequently would be developing countries. In addition, the demise of communist systems could also boost food production: Eastern European countries and the republics of the former Soviet Union have a high potential for agricultural production. In the wake of a successful transformation of their economies towards a more market-oriented system, this potential could be increasingly tapped. As a result, these countries could again become net food exporters, which they were 20 years ago. Progress in biotechnology could add to the good news for world food prospects, with less hunger and less waste of resources worldwide. However, all this will take time. Hence, hunger and malnutrition will still linger on for years and continue to lead to emigration pressures and social and political disruptions.

b. The Reform of the Common Agricultural Policy (CAP)

With respect to a fundamental reform of the world food system, the EC is supposed to hold the key. This is because the EC is one of the most important food producers and has (apart from some small EFTA countries and Japan) the highest protection rates for agricultural commodities. At the end of the road there is likely to be an agreement on major reductions in EC export subsidies for basic commodities, e.g. grain, beef, and sugar, and lower subsidies in other countries as well. World market prices would rise moderately as a result of the Uruguay Round. Less distorted (depressed) world market prices would help developing countries, Eastern Europe, and the CIS to realize their comparative advantages in agricultural production. Because of a still high share of agriculture in the GDP of these countries, an increase in agricultural production could help to improve the balance of payments — within a rather short period of time. Should the GATT negotiations fail, these countries would most probably take recourse to CAP-like protective measures for the agricultural sector.

To be sure, the recent association agreements between the EC and Eastern European countries did not really open the door to EC food markets; the import concessions granted by the EC are small by any reasonable standard. The additional transfer payments that the EC is ready to provide to these countries aim at offsetting the effect of export subsidies that major competitors, e.g. the EC or the US, pay to their own producers. These bilateral association agreements are but another step away from a multilateral approach to solving trade problems in agriculture. They impose an additional burden on taxpayers and can hardly be a sustainable substitute for a basic reform of the CAP.

There is broad agreement among experts that the EC should greatly reduce its export surplus for basic food commodities in order to improve international trade relations, limit budgetary costs, and reduce environmental damage resulting from agricultural production. But there is wide-ranging disagreement as to (i) the extent of liberalization, (ii) the means that should be applied, and (iii) the speed of adaptation. Market economists suggest a (re-)establishment of market rules to agricultural markets, which would lead to lower prices and production in the EC, and some environmental relief. At the same time the number of farms and employees in agriculture would be markedly reduced.

Interventionists, whose goal is to preserve the inherited structure of settlement, occupation, and land use in rural areas, would like to limit price adjustment and structural change by applying quantitative supply restrictions (e.g. quotas, paid land diversion) and by providing additional subsidies to be paid to farms and to farmers for raising new crops like renewable resources. This is the core of the "reform decisions" on agriculture implemented by the EC in the summer of 1992. They apply two lines of reasoning, which are not mutually exclusive:

(i) They maintain that conventional agriculture brings about positive externalities, since it preserves the "brave old world"; in order to internalize these externalities, they suggest making transfers to farmers.
(ii) Because of negative externalities of conventional farming, e.g. pollution of ground water or soil erosion, a less intensive type of farming (e.g. organic farming) is called for to reduce the application of pesticides, herbicides and mineral fertilizer.

Whereas the first line of reasoning reflects more or less the view of the official farmers' union and mainstream policy-makers, the second line of reasoning is being used by the "agrarian opposition", broadly supported by the media and backed by consumers in the higher income brackets with a low price elasticity of demand for food products and a high income elasticity for "natural" food and for an unspoiled environment. Both lines of reasoning reveal a growing awareness of the increasing scarcity of natural resources in densely populated areas and a rising opposition to modern food production methods — usually associated with large farms and livestock inventories — which are considered not compatible with animal well-being or ecological objectives. The apparent preference for small-scale farming over more efficient large-scale food production — broadly shared by the majority of those in the farm sector and the administrations in Bonn and Brussels — also translates into a protectionist attitude towards products that are manipulated genetically or that are produced using inputs from genetic engineering (e.g. Bovine Somatotropin (BST) in milk production).

The very defensive attitude vis-à-vis new developments in biotechnology could have far-reaching consequences for the location of this new industry. In agriculture, practical (field) research on genetically manipulated plants is generally carried out in foreign countries. New varieties, which could be superior to conventionally bred plants with respect to yields and resistance to diseases, are more or less banned from the EC. This will widen the productivity gap between the EC and countries in which these varieties are grown. In any event, this attitude is in conflict with the principle of origin, which is binding for the free movement of goods in the EC (e.g. the Cassis de Dijon ruling), and with GATT philosophy, which holds that the basis for phyto-sanitary and veterinary measures should be scientific knowledge and international standards subject to GATT monitoring.

The EC Commission has advanced a proposal to provide financial support for the production and usage of renewable resources. Its basic idea is to husband objectives of environmental policy with the overriding motive of agricultural policy, namely the sustained income support to farmers. Biofuels would be substituted for conventional fossil fuels, e.g. patrol or diesel oil, in order to help reduce the concentration of carbon dioxid (CO_2) in the atmosphere. The production and use of these biofuels takes place a nearly closed circle, hence there is (roughly) no net emission of CO_2. This has been put forth as an argument by the EC Commission, when it released a legislative proposal that would bind the member states to limit the fuel tax for these biofuels to 10 per cent of the normal taxes on petrol and diesel fuel. In addition, the diversion payments system allows renewable resources to be grown on land that has been taken out of cultivation for food production.

On closer inspection, this argument is fallacious, mainly for technical and conceptional reasons.[17] Moreover, the suggested cure is inadequate: if the reduction of CO_2 emissions is the generally accepted goal, the economic problem is to find the solution that has the lowest economic costs per unit of CO_2 reduction. Many experts consider the cultivation of fuel plants extremely inefficient compared, for example, with a reduction in energy use. Furthermore, the suggested partial exemption of biofuels from fuel taxes, which are raised to finance the transport infrastructure, does not seem appropriate for the purpose of environmental protection. In order to internalize externalities, a relief from a planned CO_2 tax could be warranted, although the instrument seems to be inferior to a licensing system that would put a price tag on any emission or absorption of CO_2 and/or other greenhouse gases that seem to be relevant for the climatic problem.[18] However, since the CO_2 problem is a global one, financial efforts by the EC to reduce CO_2 emissions should be directed to those locations and projects where the effect per ECU would be the largest. With respect to bio-ethanol and vegetable oil, this would certainly be not the EC but low-cost producers of agricultural raw materials in other parts of the world.

One of the traditional pillars of the official German farm policy has been the alleged superiority of the small family farm, which makes the German government favour farm policy instruments that tend to stifle regional competition and structural change, such as the introduction of milk quotas or the set-aside program. However, German unification is likely to weaken this family farm bias, since the farm sector in eastern Germany is generally characterized by large production units. This will force the administration — at least at the federal level — to give up those elements of structural and social

---

[17] For a detailed discussion, see Jörg-Volker Schrader, Volkswirtschaftliche Bewertung der Nutzung von Energiepflanzen. Institut für Weltwirtschaft, Kiel Working Paper, 425, June 1990.

[18] For a detailed analysis of the licensing system, see Johannes Heister, Peter Michaelis et al., Umweltpolitik mit handelbaren Emissionsrechten. Kieler Studien, 237, Tübingen 1990.

policy that discriminate against larger farms. Hence the as yet lop-sided German position on the conservation of a traditional farm structure may become somewhat more flexible in the future.

6. European Integration

a. Monetary Union

The design of monetary and fiscal policy is of essential importance for macroeconomic stability during the transition to and the early phase of the European Monetary Union (EMU). From a "German" point of view, which could be defined as a quite broad consensus of the political elite and the population at large, it seems most important that the common monetary policy assures price level stability, and that fiscal policies in the different member countries will be compatible with this aim.

To understand German anxieties, it is worth recalling the historical record. In this century, Germany has experienced not only periods of high inflation and hyperinflation but also two major currency reforms (in 1923 and 1948) which were undertaken to put an abrupt end to highly unstable monetary regimes with disastrous consequences for the savings and asset holdings of the man in the street. Therefore, it is quite natural that the German population by and large has a strong preference for a stable price level, probably more so than people from other countries. This finds its expression in the comparative record of price stability since the early 1950s which shows that the inflation rate in Germany has been consistently among the lowest of the OECD countries. As is widely recognized, the staunch adherence to price stability targets has established a leading role for the Deutsche Bundesbank in shaping the stance of monetary policy in the European Monetary System.

The scepticism of the German public with regard to the effects of the currency reform in Europe is based on mainly three unsettled issues:

- When the ECU is introduced, the conversion of savings and debts should be completely neutral. While this may be a condition which looks self-evident, the experience with former currency reforms suggests otherwise. Therefore, fears on the side of savers remain that the change will imply some sort of debt repudiation; this has been discussed especially in connection with countries in which the level of government debt is extremely high. The concern that this will negatively affect the wealth position of savers still has to be eliminated by credible policy commitments.
- Price stability is not unambiguously defined. Although the term has an obvious meaning — the price level should be stable and neither rise nor fall over an extended period of time — there is plenty of leeway for interpretation in actual practice. If one accepts that the inflation record of a country is a good proxy for the preferences of the national public, it is obvious that there are countries which are less inflation-averse than the Netherlands and Germany, and, more recently, also Belgium, France, and Denmark. The general expectation, therefore, is that the inflation rate in EMU will move to some sort of average which is likely to be higher than in the most stability-oriented countries. While the Treaty of Maastricht seems to promise more stability, there is no mechanism which will enforce this commitment. This makes the promise questionable.
- Apart from the fact that the governors of the European Central Bank (ECB) will come from countries with different preferences on price level stability, it is an open question whether the ECB will be in the position to pursue a truly independent policy of low inflation. To be sure, the Treaty of Maastricht does feature the independence of the ECB; nevertheless, actual policies may be influenced by outside political forces through the backdoor; for example, the notion that the ECB has to support policies of the EC raises doubts whether the target of price level stability will always have priority over other goals such as (temporarily) low unemployment and ac-

celerated growth. Furthermore, the ECB does not have a clear-cut competence for exchange rate policies vis-à-vis other currencies. According to the Treaty of Maastricht, there may be exchange rate arrangements with other major currencies such as the US Dollar or the Japanese Yen which may limit the factual independence of the ECB and may thus hinder or even jeopardize a policy directed solely at price level stability.

All these open issues contribute to the uncertainty as to the actual monetary policy that will be pursued in EMU. It will require a lot of reassurance from governments that price level stability is indeed the priority for the ECB. The discussion of these issues will probably intensify quite dramatically in the years ahead unless there is a clear commitment — possibly in the form of a well-specified rule for monetary policy — which may alleviate the concerns of the business community and the public.

The expectation that inflation will be higher in EMU than in Germany is also based on the uncertainty with respect to the procedure that will lead to the final stage of EMU. It is an open question whether the criteria for membership which are mentioned in the Treaty of Maastricht will play any distinctive role. While these criteria are clearly stated, they are not binding so that the decision whether a country can become a member of EMU or not is to remain a political one. The interpretations by the member countries, however, may not be compatible and may thus become a source of conflict. An extreme position is taken by the Bundesbank itself which has made it clear that a strict application of the rules is essential for a successful start of EMU. Obviously, this position is not shared by all partners. Therefore, a conflict may arise in the near future in which the Bundesbank, along with other authorities with a bias towards stability, will have to defend parts of the Treaty of Maastricht against other partners who may be inclined to undermine the substance of its stability content.

If in the end the rules are not taken seriously, the desired convergence of major macroeconomic variables is not likely to occur. In this case, it would be difficult to convince the public in Germany and elsewhere that rules will be applied in the future if they have been disregarded in the past. If, however, the criteria do play a major role in shaping EMU, the second stage which will start in 1994 will become an extremely critical one since budget deficits will have to be reduced over the medium term in a number of countries and monetary policy will have to be directed towards price level stability in a much more decisive way than in recent years. This will put a large burden of adjustment on labour and capital, i.e. on unions and firms in these countries. Furthermore, it may become very difficult for the respective governments and central banks to resist the temptation to resort to expansionary measures which may jeopardize the stability aims. At the same time, it is likely that the countries which are more inflation-averse than the average will be heavily criticized. The danger is that such criticisms will be interpreted by the German public as a move of the more inflation-prone countries away from the priorities of EMU. Again, this will raise the concern that price level stability is not really the top priority in the monetary union.

A logical consequence of a currency union is that external shocks hitting single national or regional economies cannot be accommodated by changes in nominal exchange rates. Thus, the real adjustment pressures on firms and unions will mount. At the same time, demands for compensatory fiscal policies will be forthcoming and will add a further burden to the Community budget which could only be financed either by a reduction of expenditures in member countries — a rather unlikely event — or by an increase in taxes. It is not to be expected that tax increases are easily accepted, especially if they are due to a lack of adjustment flexibility, for example, in peripheral regions of the community. It therefore seems essential that the authorities on the EC level make clear from the beginning that they are not willing to use the instrument of regional fiscal policy to alleviate problems created by, for example, wage rigidities. Otherwise the support for EC policies by the public — particularly in Germany — is likely to diminish, even much further than it already did in recent times.

It is important to realize that arguments of stability and of inter-EC transfers are not the only pillars on which the widespread disillusion with European monetary union is based in Germany. This has become clear in the most recent months after Maastricht when two other frontlines began to open. On the one hand, there are critical voices — notably in the Social Democratic Party — who argue that the Maastricht Treaty has an undue bias towards economic and monetary matters without offering much prospect for a politically unified Europe. On this view, Germany has paid too high a price not by surrendering monetary stability per se, but rather for not receiving anything valuable in return in terms of, for example, a strengthening of the powers of the European parliament. On the other hand, there are representatives of the German states (Länder) who strongly oppose a further transfer of legislative powers away from the state, be it the government in Bonn/Berlin or a multilateral institution in Brussels; on a more down-to-earth level, they also want to have a stronger voice in EC negotiations on the budget.

These two lines of critique have gained considerable weight in the public discussion due to the fact that the Maastricht Treaty has to be ratified with a two thirds-majority in the Bundestag (the parliament) and in the Bundesrat (the chamber of the Länder representations). To be sure, they do not amount to anything like the deep-seated Euro-scepticism which may result from inflation anxieties that can be exploited by populist right-wing parties as happened in recent state elections. Instead, they are more of a dissent within the political establishment itself. Although they did not lead to a failure of ratification, they may add an important element of unease and discontent over the future of European integration to the public debate.[19]

b. Financial Markets

Germany's financial intermediaries (stock exchanges, insurance companies, commercial banks, investment banks, investment funds, and related services) seem to be heading for a stormy future. Profound changes in business conditions have to be expected, meaning in particular that financial services — in the past once truly domestic industries under shelter and supervision of domestic regulatory systems — face the prospect of relentless and pervasive competition in open markets. Of course not everything is new with this. In many respects it is rather an ongoing evolution of structural change in financial markets. Since the early 1980s or so, domestic deregulation in many industrial countries and rapid innovation in information technologies have unleashed a growing globalization of competition in financial services; once set in motion, this globalization has become a self-sustaining process. With financial capital free to move internationally, countries adhering to old-fashioned regulations have been subject to increasing pressure to change course in order to avoid the loss of business to abroad. The changes in the regulation of financial futures markets — rather reluctantly taken by the German government in recent years — are a case in point. In a more general consideration, the ongoing public debate on the international competitiveness of Germany's financial institutions (of the "Finanzplatz Deutschland") which started a couple of years ago is a strong indication of the repercussions between national markets reflecting the increasing globalization of these businesses.

Furthermore, the progressive completion of the European internal market in financial services will largely curtail the autonomy of the German government to regulate these markets domestically. National governments will only retain some freedom to set stricter rules for domestic financial intermediaries than is laid down in the core regulation by the Community for all member states. The principle of the country of origin is to ensure, however, that peculiarities of national regulatory systems do not impede market access for financial services legally offered in the markets of other member states. In addition, the realization of the EMU by the end of the 1990s which was agreed upon at the Maastricht summit in December 1991, would not only mean the introduction of a single currency but also the

[19] For a summary of the various critical views, see Financial Times, "Kohl Struggles to Land His Catch". 17 March 1992.

existence of a uniform monetary-policy regime including those market regulations for financial services which are set by the central bank.

In recent years, the public debate in Germany has shifted towards an almost general approval of the completion of the internal market in financial services. Opposition has been articulated at the extreme ends of the political spectre, and by companies and industry associations where vested interests seem to be at stake. For instance, representatives of the insurance industry have argued that too fierce a competition in a less regulated internal market would erode achieved standards of consumer protection in Germany. Other complaints and fears brought forward by representatives of financial industries do not concern the prospects of the internal market as such rather than the fact that the German government has imposed or is expected to impose stricter national regulations than is required by Community law. For example, pure money-market funds have not yet been authorized in Germany. Domestic citizens and institutions wanting to put money into investment funds of this kind, can do so only in other member states or in third countries. And regarding the pending adjustment of rules for equity-capital requirements in commercial and investment banking, it can be expected that the national provisions will turn out to be relatively tough. Such an outcome is apparently preferred by the Bundesbank.

The introduction of a single European currency will, of course, profoundly change competition conditions in financial services. Trans-border transaction costs in the single market, which at present are in many instances ridiculously high, will be substantially reduced. This will mutually ease the market access between member states and open up additional choices for customers to buy financial services at the cheapest source of supply in the single European market. Thus, it can be expected that the introduction of a single European currency will be a powerful engine for furthering the interconnection between national financial markets and for a European-wide restructuring of the financial industries. One has to take into consideration, however, that a single currency also means a single monetary policy and a single regulatory system for financial services in the framework of the competence of the European central bank. The implications on financial markets will much depend on the policy actually pursued by the European central bank. With policy competition between member states abolished, business competition in financial markets will be based on equal conditions across member states. Financial centres with little regulations at present, such as Luxembourg, will tend to loose their artificial attractiveness in relation to other European financial centres. But the European central bank may be tempted to establish tougher regulations than would have been the outcome in a single market with competing national monetary regimes, and to impose also relatively strict regulations in relation to third countries. With the large-country temptation being effective in the suspected manner, the gains from internal liberalization as promoted by the single currency would of course be reduced. Such a suspicion is not far-fetched, as it may seem at first glance. In fact, many observers have diagnosed behavioural patterns of this kind in various other areas of Community policy, not least in commercial policy.

It is sometimes argued that importance has also to be attached to the choice of the headquarters for the new European central bank. Aspects of national prestige apart which are quite naturally involved in the process of making such a decision, the argument reflects the expectation that the financial centre at the seat of the central bank has a competitive advantage in financial services for this very reason. In this context, German observers have in mind the post-war rise of the financial centre of Frankfurt. In this case, the location of the Bundesbank seems in fact to have given Frankfurt a decisive edge in competition with other regional financial centres in western Germany, while the former leading financial market in Berlin remained paralyzed for the well-known political circumstances. In a broader perspective, historical evidence — note that the history of central banks in the modern meaning is a relatively short one — seems to be somewhat inconclusive and facing a hen-egg kind of problem with respect to the identification of causalities: was the central bank of a country once set up at a place were the financial business was concentrated, or did the financial business prosper at a place where the central bank was set up in the first place?

In any event, hosting the European central bank will certainly not be a disadvantage for the growth prospects of whatever financial centre so that one should expect the German government to fight hard for Frankfurt not only to soothe the stability fears of a German population, which would no doubt have more confidence in a Frankfurt-based than in any other European central bank, but also to give Frankfurt an additional trump card to play in the game of locational competition against other European financial centers like Zurich, Luxembourg, and above all, London. As financial services tend to involve high economies of agglomeration as the heavy concentration of the international finance community in a few big cities or even quarters and streets of cities shows, this kind of pro-business lobbying of the government may be quite rational after all. It may also help to sharpen the minds of regulators in Frankfurt to adjust the still rather inefficient and unattractive legal framework of trading conditions in Germany's financial markets. In fact, a well-timed recent "political visit" of the German chancellor to the stock exchange in Frankfurt had exactly this effect.[20]

All in all the German financial industries seem bound to be confronted with unprecedented challenges over the next two decades or so, through the continuing globalization of competition in financial markets in general, and through the completion of the European single market in financial services. But risks and opportunities involved are likewise relevant for the financial industries in other European countries. The familiar notion that the German economy is, in relative terms, a "giant" in industry and trade, and a "dwarf" in financial services, may contain more than just a grain of truth as can be inferred when comparing German stock exchanges with those in the United Kingdom or in the United States. It cannot be taken, however, as a valid assessment of the competitive strength of German financial industries in general, and particularly not so in the context of the emerging single European market. Anyhow, it would be rash, and certainly erroneous, to make predictions on the basis of past experience with regulated markets. Progressive liberalization of financial markets will increasingly level regulatory conditions across countries.

c. EC Initiatives on Social Policy

The Maastricht Treaty has, in its Protocol on Social Policy, expressed the endeavour of the member countries — with the exception of the United Kingdom — to "continue along the path laid down in the Social Charter of 1989". The Community has acquired a mandate to issue, with qualified majority (i.e. at least 44 votes), directives on minimum requirements for gradual implementation in the fields of (i) the working environment to protect workers' health and safety, (ii) working conditions, (iii) information and consultation of workers, (iv) gender equality, and (v) the integration of persons excluded from the labour market. The Council is bound to consult the Economic and Social Committee on these issues. The threshold is higher — unanimity, consultation of the European Parliament in addition to the Economic and Social Committee — in the areas of (i) social security and social protection, (ii) dismissal protection, (iii) representation including co-determination, (iv) legal immigrants, and (v) financial contributions for promotion of employment and job-creation. Furthermore, the involvement of management and labour in social policy activities at EC level has been broadened substantially: (i) on their request, they can be entrusted by the Community with the implementation of directives in the areas mentioned above, (ii) the Community endorses the extension of the dialogue between labour and management to contractual relations including agreements. Note the oddity that the United Kingdom has excluded itself from the protocol agreement, but that British members of the European parliament and delegates to the Economic and Social Committee can voice approval or disapproval of the proposals in their respective institutions.

[20] See Financial Times, "Politics come to the Finanzplatz". 24 January 1992.

The Social Charter has explicitly been subjected to the principle of subsidiarity meaning that action should be taken at Community level only when the respective aim cannot be reached better at the level of member states. The Community is claiming competence in the area of social policy because, in her view, the reduction of differences among the national social regulations is necessary to equalize competitive conditions among the member countries. The normal operation of market forces, harnessed by the completion of the common market, could be at the disadvantage of the poorer member states and of those groups of workers who are in need of protection. Thus, the achievements of the single market could put the "social consensus" at jeopardy, justifying to lay a floor of broadly accepted minimum requirements in social regulation.

Whether the claims for competence of the Community are warranted is open to doubt, at least from the standpoint of economic analysis. First, the regional incidence of the expected positive effects of the common single market is hard to predict. Second, it is very controversial whether the interference with the freedom of contract for the sake of distributional objectives can be justified even at national, if at all at the international level:

- As to the regional distributional aspects of 1992 Northern European countries should expect relatively small benefits from the completion of the internal market, because they are already well integrated with one another. The main beneficiaries of the 1992 programme are likely to be the Southern European countries, both in terms of exploiting comparative advantage and in terms of exhausting scale economies. Hence, regional disparities would level off in the wake of integration. On the other hand, it is argued that the creation and diffusion of knowledge are the main determinants for the evolution of competitiveness. In that respect, the core regions of the EC are better placed than the peripheral regions, which would give them a competitive edge and sharpen regional disparities. However, these positions are not mutually exclusive: to exploit their comparative advantage and not to impinge on the effect of scale economies, the relatively backward regions would need to play the card of factor-price advantages in the catch-up process; and the core regions need to foster innovativeness to improve their growth potential. Integration is not synonymous with increasing regional divergence and does not provide a clear-cut justification for the Community to intervene on behalf of the cohesion objective.
- As to the distributional aspects of social regulation on specific groups it is useful to allude to the "boomerang effect" in those instances of national regulation where social regulation raises the relative price of those target groups that should benefit from this regulation (in general, the higher costs due to regulation are hardly offset by reduced money wages or increased productivity). The extended power, that has been allocated to the Community in the Maastricht summit meeting, will be used to speed up the implementation of the Action Programme that goes with the Social Charter. The mandated benefits will raise labour costs in the same way as it is the case for similar (national) actions of member governments: they will very often disproportionately affect the costs of the less productive workers. From this perspective, therefore, the Social Charter does not seem to offer an effective means of achieving the expressed goal of social equality. It is unlikely that action at Community level along the lines of the Action Programme is apt to better attain the objectives of Art. 117 of the Maastricht Treaty than if it were left to national authorities. Hence, there is no a-priori reason to believe that, on the basis of the subsidiarity principle, action at Community level is in general warranted.

The EC member states differ substantially in the way in and the extent to which labour markets are regulated. Furthermore, apart from regulation proper, enforcement practices vary broadly as between countries. These differences are specific aspects of the locational characteristics of each of the countries on which basis these countries take part in the competitive process. The set of locational characteristics could be perceived as a kind of complex equilibrium in which differential regulations are needed in order to cope with specific peculiarities in the respective countries. A case in point is the United Kingdom which, because of overregulation in markets such as housing, needs a rather deregulated labour market.

To assess whether a harmonization of social standards is appropriate, the consequences of higher social standards in poor countries should be looked at in some more detail:

- There is a marked regional decline in per-capita income and labour productivity from the EC core regions (western Germany, Benelux, London, Paris, Milan) to the periphery in the Northwest (Ireland, Scotland) and the South (Portugal, the South of Spain and Italy, Greece).
- A similar regional pattern can be seen in wage costs (including indirect costs determined by regulation); the decline is less steep, however.
- The regional discrepancy between wage costs and labour productivity affects the labour market performance with unemployment and underemployment relatively higher in the periphery than in the core regions.

A mandated rise in social standards would, unless it is met by respective increases in productivity, contribute to higher unemployment in those regions. To avoid or simply mitigate these unintended consequences, it would be necessary to prop up substantially transfer payments such as regional aid or social funds. The doubling of the structural funds in the EC budget from 1988 to 1993 is a case in point. And the qualms that have just started in the vein of the most recent EC budget proposal highlight this odd trade-off.

One motive behind the Social Charter and the Action Programme is to avoid "unfair" competition in the form of "social dumping". Obviously, an asymmetrical treatment of locational characteristics is implied: locational advantages of a rich country, such as a well-developed infrastructure, highly-skilled workforce, are perceived as fair, whereas the locational advantages of poor countries, such as low labour costs in terms of money wages and effective social regulations, are perceived as unfair. This is the old-fashioned protectionist pauper-labour argument. However, there is nothing inherently unfair in a competitive process. On the contrary, the cost differences call forth mutually beneficial trade which in the long-run tends to diminish these differences. And it is not at all objectionable that differences in income materialize in different preferences for leisure, education, security, and worker participation. Yet a problem of fairness may arise when rich countries endanger their own competitive position by not paying enough attention to balance productivity and costs and take recourse to protectionist policies when being contested in the market place. Hence, the fairness issue is more with the rich countries and not with the poor.

To the extent that the Social Charter raises labour costs in the backward countries of Europe it gives incentive to curtail net capital exports from the center to the periphery. This may in the long run hamper the catching-up process in these countries, sustain and even broaden the regional wedge in per-capita income. Furthermore, there are concerns that an administrative harmonization of social regulation may inflict with another goal of Art. 118 of the Maastricht Treaty, namely to "avoid imposing administrative, financial and legal constraints in a way which would hold back the creation and development of small and medium-sized undertakings". In general, employees of large firms enjoy better working conditions, pay, representation and codetermination, security and the like than small and medium-sized firms. Minimum standards would hit the latter most. Large enterprises have, in addition, a louder and more respected "voice" in the collective institutions on either side of the market. Since unions and employers' associations play an important role in the process of practical social policy, there is an implicit bias against small and medium-sized firms in the political process anyway. The new Maastricht provisions which encourage management and labour to actively taking part in the formulation of social policy proposals in terms of minimal standards will give the larger firms an additional advantage at the European level.

It is to be expected that the eleven relevant member states will focus their activities on health and safety issues as well as working conditions. First, the threshold is lower in terms of qualified majority voting. Second, it is quite popular to justify mandated minimum standards in this area on the basis of perceived market failures such as adverse selection and asymmetric information. However, the market failure argument needs careful consideration: one should not lose sight of the fact that the labour market will react itself with compensating wage differentials on varying degrees of risk and hazard. Furthermore, if insurance were more based on risk than on income than it uses to be in most European countries, there would be a direct effect on insurance premia and, hence, money wages for dangerous activities. Mandatory minimum standards are not costless. Whether costs, e.g. transaction costs, are lower in the case of government intervention remains to be shown. In any case, these costs may affect total employment costs quite considerably. In the case of Germany, mandatory social standards on health and safety contributed strongly to the rise of indirect wage costs, thus giving incentive for the expansion of the "black economy". Keeping regulation-induced costs in balance with productivity is crucial for not violating the objective of Art. 117 of the Maastricht Treaty which explicitly mentions the promotion of employment.

Finally, the advance towards EMU would put additional strain on the flexibility of factor prices, once the exchange rate buffer disappears. It is open to doubt whether the instruments flagged in the Action Programme of the Social Charter are apt to help adjust in case that shocks have to be absorbed via transmitting them in a higher flexibility of wages.

In any event, even if one would not go so far as to say that the Social Charter is counterproductive for the objectives that it is aiming at, there is a case for being extremely cautious in going quickly further down the road outlined in the Action Programme. It is indispensable to force politicians to take second round effects into account in order to avoid ending up in the need for gigantic transfer payments. These, in turn, could really blow up social cohesion by ruining the willingness to pay of the taxpayers in the net-payer countries.

Notwithstanding the sceptical views of economists, the EC initiatives on social policy have so far received a quite positive reception in Germany. Naturally, unions and welfare state administrators are very much in favour of exporting the German labour market regulations and the tight social security net to other countries. Employers' associations are somewhat more sceptical as they find themselves in a dilemma: to the extent that they see a protectionist opportunity to curtail foreign competition ("social dumping"), they support an international harmonization on the EC level; however, to the extent that they see this very competition as a vehicle to exert pressure on the costly German labour market regulations, in particular the system of extensive codetermination, they oppose the harmonization efforts and instead support a more or less unfettered "competition of welfare states". In politics, virtually all parties have a positive attitude towards the EC social dimension, with the degree of enthusiasm being a function of how ideologically close the parties are to labour and business: while the Social Democrats and the left wing of the Christian Democrats strongly favour the harmonization efforts, the business wings of the Liberals and the Christian Democrats take a much more critical stance.

All in all, the whole issue of social harmonization has remained at the backstage of political controversy; so far, it did not remotely receive the attention it has in Britain. This may change in due course, if the EC becomes less popular in the wake of the preparations for a monetary union. Even then, however, it will not compete in importance with the much more emotionally laden question of whether or not to give up the beloved D-Mark.

II. Internal Challenges

1. German Unification

Outside observers might be inclined to regard German economic unification as no more than a short-term distraction of German politics which will phase out as soon as the transformation of the post-socialist eastern German economy has been completed. To be sure, huge public investments — mostly financed by the West — will certainly remove the most urgent bottlenecks in the physical and the administrative infrastructure so that the present extreme capital shortage of the eastern German economy will be largely overcome after 5 to 10 years from now. In other respects, however, there are good reasons to expect German unification to have sustained consequences for Germany's economic and, hence, political future. Broadly summarized, the most likely medium- and long-term changes may read as follows.

a. The Rising Fiscal Burden

In the first wave of political euphoria after the wall had come down, the economic costs of unification were vastly underestimated by the political class and large parts of the public. By now, it should be altogether clear that the great public tasks — building up a modern physical and administrative infrastructure, mitigating disastrous environmental damages, privatizing and restructuring a decrepit industrial capital stock, and supporting a rapidly rising number of unemployed people within the framework of the generous western welfare state provisions — have turned out much more expensive than expected, not least because the collapse of production in the eastern part of the country has surpassed all prior predictions. The drastic increase of public expenditures, which is partly hidden in newly created (and euphemistically named) funds outside the official budgets, was at first regarded to be strictly temporary. However, all economic indicators now show that this will most probably not be the case so that the steps taken so far — the sharp rise of petrol taxes, the rise of the standard value added tax rate from 14 to 15 per cent by 1993, the imposition of a (temporary) income tax surcharge — levied for just 12 months, and the rise of payroll taxation will not be remotely sufficient to balance the books in the medium and long run. Sure enough, further tax increases are now on the political agenda: it is most likely that, by the mid-1990s, an income tax surcharge will be reintroduced and a few other taxes raised (notably the petrol tax).

More generally, the question of consolidating public finances will become something of a permanent theme of German politics again, as it used to be for a while in the late 1970s and early 1980s, with the likely outcome being some rather ad-hoc combination of expenditure cuts in the western part of the country (especially of subsidies), a postponement or watering-down of planned tax reductions, notably on business profits some further tax increases, and, most importantly, a permanently higher fiscal deficit. To be sure, the deficit will not be monetized by the central bank which is likely to stick to the not unpopular German-style policy of tight money and low inflation; in view of the prospective convergence targets of macroeconomic stability in the EC to be met by the mid-1990s, the German Bundesbank will have an easy political justification in public to defend an uncompromising stance. Hence, real interest rates — at record levels already — may well continue to stay high in the coming years which will allow Germany to "export" part of the adjustment burden to other countries, just like the Reagonomics in the early 1980s did for the United States. If — a big if — the real rate of return on investment in Germany — notably in east Germany — will be sufficiently high, such a policy may well be justified as it would then not tend to undermine the still excellent credit rating of the German government and the locational attractiveness of the country for foreign investment. However, as a large part of the transfers to the east go into private consumption, things may look different: given the extreme inertia of social spending, which is politically very hard to cut back once "institutionalized" as, for example, in the form of unemployment benefits, the odds appear to be well in favour of a worsening in the attractiveness of the country for foreign investment, at least in the medium term, but maybe also in the longer run.

b. Economic Dualization

By the mid-1990s, there will emerge a dual economy in the east consisting of a rather modern, highly capital-intensive segment and a subsidized old one with long-term unemployment remaining much higher in east Germany than in the west. The basic reason is that collective bargaining in unified Germany has opted for a very rapid equalization of wages between the west and the east in major industries by 1994, despite the vast and obvious labour productivity differential. These terms reflect the endeavour to avoid mass migration and wage competition.[21] The burden of creating incentives for private investment in the east was thus put on public subsidization. The federal government in fact swiftly provided a large and generous menu of investment aid items which amount to an effective rate of subsidization of between 30 and 50 per cent, seconded by comprehensive labour market measures to mitigate social disruptions in the adjustment of hopelessly overmanned enterprises. In the medium and long run, this emergency help will be fiscally unsustainable and will give way to more moderate aid packages. In addition, even if the Treuhandanstalt (the holding company of eastern German formerly state-owned enterprises)[22] finishes up its prime task of privatization on schedule, i.e. in about two years, there will no doubt remain a significant residuum of unsaleable industrial capacity which will be heavily concentrated in certain eastern industrial regions. Pressures will mount that this capacity should continue to operate at high rates of subsidization. Basically, this will be a replay of the structural crises witnessed in western regions like the Ruhr district and the Saar valley in the mid-1970s and early 1980s. The difference will be the sheer extent of the crisis and its long-term consequences: while, after restructuring, the sunset regions in the west were left with still tolerable unemployment rates of 10–15 per cent, the rock bottom of non-cyclical unemployment in the east may easily amount to more than 20 per cent of the labour force. Hence, while the transformation of the eastern economy may be basically successful in initiating a sustained revival of industrial activity, it is unlikely to be powerful enough to lead to a full-scale reintegration of the eastern workforce at western wage levels.

The dualization of the eastern economy will be further accentuated by what may be called the vintage effect of investment: as the industrial capital stock in the east is renewed at an unusually fast speed, the average vintage of technology and thus the average level of labour productivity (output per man-hour) will turn out higher in the east than in the respective industrial activity in the west, at least for a possibly rather long period of transition.

Only after the gradual rejuvenation of western industrial capacity through reinvestment and the gradual aging of the eastern capital stock will have reestablished a balanced age structure — say, in two decades — will the east/west vintage and productivity gap be closed. In the meantime the east will have to live with a segment of industry, which is hyper-modern even by western standards, side by side to the run-down capacity remnants of socialism. To some extent, such a vintage-dualization is certainly the unavoidable consequence of any transformation from socialism to capitalism and thus per se nothing to worry about. However, to the extent that the sheer presence of a hyper-modern sector in the east helps to drive up wage demands in the east, there will be a negative side effect on the labour market. Unfortunately, this is likely to be the case since unions tend to orientate their wage demands not at the state of a (regional) labour market; in addition, the employers' side at the bargaining

[21] For a more detailed evaluation of the reasons for east/west-wage equalization, see Section II.3 below.

[22] In the following subsection below, a brief summary of the record and prospects of the Treuhandanstalt is given.

table is likely to be dominated by an odd coalition of "new" firms operating with a highly modern capital stock and of highly subsidized "old" firms so that wages are unlikely to take due account of high and persistent unemployment. Hence the prospects for a self-correction of labour market dualization in eastern Germany may be bleak, even in the longer run.

Experience in Germany shows that — once fixed — collective agreements are hardly adjusted ex post to the detriment of the employed workforce, even with sky-rocketing unemployment. In particular, pronounced and sustained regional disparities in the jobless figures do not trigger any corresponding inter-regional wage differentiation. Hence, it is highly unlikely that collective bargaining will be flexible enough to take account of the remaining long-term gap in unemployment between east and west.[23] Instead, pressure on government to continue subsidization will mount. However, whereas in earlier structural crises, these pressures could be fiscally accommodated without too much turmoil, the extent of unemployment in the east will make much more drastic fiscal measures necessary, with the federal government most likely to foot a large part of the bill. In the same vein, the structure of German-style fiscal federalism will have to be completely overhauled to the advantage of eastern regions. All this will add a sizeable permanent burden on the public budget. In this sense, Germany will not quite be the same again: as a unified country, it will have to endure larger internal economic disparities and somewhat tougher redistributive quarrels over tax money than its western part ever had to in the past.

c. Digression: The "Treuhand" Record and Prospects

The Treuhand was founded in March 1990 by the late GDR-government as a holding company of basically all East German state-owned enterprises. Practically, it started its work after German unification (3 October 1990) when it was assigned three major tasks, namely the restructuring, the privatization, and the demonopolization of existing firms. The legal task assignment does not provide any guidance to the hierarchy of these aims; in particular, there is no explicit priority given to privatization. Therefore, in practice, much depends on the strategy of the Treuhand's management and its supervisory board as well as on the governments on the federal and the state level, notably the Federal Minister of Finance, who sets the frame in which the Treuhand is extended credits and credit guarantees; in addition, the federal government has a major influence on the choice of the Treuhand's supervisory board. Hence, although legally no political institution, the Treuhand is bound to be subject to the political will of the government and to all standard political pressures from outside lobby groups.

Given this uneasy political framework, the Treuhand's record up to the present looks remarkably successful. The privatization of small firms and shops in the service sector had nearly been completed until the end of 1991. As of late December 1992, from the stock of 13,000 larger firms — most of them in industry —, 56 per cent had been privatized, and 3 per cent had been taken over by local governments; 19 per cent had been put on the way towards liquidation. In terms of jobs, 34 per cent of all employees of the Treuhand firms now work in firms which have been privatized, while about 11 per cent are still with the Treuhand; the remaining 55 per cent has become unemployed, retired, self-employed, is participating in qualification measures, or — to the smaller part — has found new jobs in private firms.

While this record is quite impressive, the problem is that privatization speed is likely to slow down considerably in the near future. This is so for economic and political reasons. Economically, the commercially most attractive firms could be privatized first so that the remaining stock will have an ever rising share of plants which suffer either from conflicting property claims or from a particularly run-down capital equipment. Politically, the resistance of employers, unions, and state and local gov-

[23] For a more detailed account of collective bargaining and unions' wage policy, see Section II.3 below.

ernments will grow with the likelihood of massive lay-offs which will be concentrated in certain branches and regions. A good case in point is shipbuilding in the northernmost eastern state of Mecklenburg-West Pomerania where the scheduled privatization led to a genuine political crisis in early 1992. In short: the more the Treuhand approaches the hard core of the matter, the slower and the more politically controversial will any further privatization become. A likely scenario seems to be that the Treuhand will rather easily proceed in privatizing the bulk of the smaller firms. In turn, it will become particularly difficult to privatize those larger firms which are concentrated in backward regions such as Mecklenburg-West Pomerania, parts of Thuringia, and the area to the west of the border to Poland, in branches with very severe transformation problems such as chemicals or mechanical engineering, and in branches which face bleak long-term prospects anyway such as shipbuilding, mining, iron and steel as well as textiles and clothing. These will turn into a long-term burden, which will form the gloomy part of the dualized economy sketched above.

d. New Regional Growth Patterns

German unification together with the economic transformation of Eastern Europe is quite likely to have initiated a profound change of the regional growth prospects in the future, both in the western and in the eastern parts of the country.

In the west, the last four decades have been a time of a rather stable pattern of regional growth, with the industrial centers of the Rhine/Ruhr and the more southern Main/Neckar valleys quite persistently figuring as the pacemakers of development. Only two major trend changes could be observed:

— the gradual loss of growth dynamics during and after the two oil price shocks in the regions where major sunset industries were concentrated, namely the Ruhr and the Saar valley with coal mining and the steel industry, the northern coastal shore with shipbuilding, and, to a lesser extent, Westphalia with textiles and clothing;
— the rise of Southern Bavaria, especially Munich, and of the Frankfurt metropolitan area, as major centers of manufacturing and services which profited most from the decline of West Berlin, the western part of the former capital, that lost part of its manufacturing base due to its geographic and economic insulation.

Of course, there were some perennial "problem regions" whose economic performance quite consistently lagged behind the average in terms of per capita income and/or of unemployment, most of them areas with some inherent locational disadvantages; apart from Berlin, these were the coastal shore and hinterland of the North and the Baltic Sea, and — most importantly — a 50–100 km strip of land along the Iron Curtain, reaching from the city of Lübeck at the northern-most point of the inner-German border down to the Bavarian Forest neighbouring Czechoslovakia. Even with ample public support for these regions — above all the so-called horizontal fiscal equalization (Finanzausgleich) between rich and less well-off states — the economic gap between them and the rest of the country could never be substantially narrowed.

German unification and to a lesser extent the prospective transformation of Eastern Europe have brought some definite changes to this pattern. With the re-establishment of trade and transport links to the East, all artificial handicaps of locations along the former Iron Curtain have disappeared or will disappear in due course. In fact, some of the previously handicapped locations now enjoy distinct advantages from the standpoint of a potential investor. This is certainly true for the capital Berlin, which, apart from becoming the seat of the German government, now finds itself geographically well placed to resume its pre-war role of a metropolis right at the crossroads between Europe's East and West. It is also true for the industrial areas near the former inner-German border, e.g. in eastern Lower Saxony, nothern Hesse, and northern Bavaria, which are turned from the eastern periphery of West Germany into central regions of a united Germany, with a complementary industrial hinterland in the eastern states of Brandenburg, Saxony-Anhalt, Thuringia, and Saxony. The most likely losers in this reshuffling of growth potentials will be precisely those regions which profited most from the division of Germany in the first place, notably southern Bavaria, the Rhine valley and the Frankfurt metropolitan area: in particular, many firms may return their headquarters from Munich, where they had moved after World War II, to their traditional home Berlin, and many government-close service branches are likely to follow the trek of bureaucrats and lobbyists from the Cologne-Bonn-urban area to the new (and old) capital.

Within eastern Germany, the industrial heartlands of the pre-war period, which are to be found in the states of Saxony, Saxony-Anhalt, Thuringia and southern Brandenburg will enjoy similar locational improvements as their counterparts in Lower Saxony, Hesse, and northern Bavaria. Notwithstanding the chronic structural problems of labour market dualization, which have been described above, they will certainly be the most attractive locations for industrial investment in the eastern part of the country. However, due to their relatively high wages compared to neighbouring regions to the East — notably Bohemia with its formidable industrial tradition — they will not be the favourite place to establish "extended work benches" for western firms to save on labour costs. The economic prospects will look more gloomy for the northern regions of eastern Germany: while the state of Brandenburg will still profit from the growth dynamics of the city of Berlin, the northern-most state of Mecklenburg-West Pomerania is likely to remain the country's poorhouse as it used to be in the pre-war period. Hard hit by the deep crises of its main economic sectors — shipbuilding and agriculture — and lacking the strong locational advantages of the regions south of Berlin, Mecklenburg-West Pomerania will have to rely very much on exploiting its touristic potential — the coast of the Baltic Sea, a large number of lakes and a thinly populated green countryside — and on developing transport facilities linking Scandinavia to eastern Germany and southern Europe. However, this potential is hardly sufficient to prevent unemployment to emerge on a scale which is unknown in other parts of Germany.

Since German unification, many fears have been voiced that the prospective resurgence of Berlin as a European metropolis and as the German capital will lead to a new unwelcome trend towards centralization, i.e. to the days of the "Kaiserreich" and the Weimar Republic when Prussian dominance had very unwelcome consequences; this picture is then often contrasted with the high degree of decentralization which characterized West Germany and the Bonn republic, with a strong dose of federalism injected into the political system, and a relatively large number of about equally sized urban centers scattered all over the country competing for economic excellence. On closer inspection, this argument does not carry much weight. Politically, the strongly federal constitution of the "Bonn republic" has been fully preserved in the course of unification, and there is not a single large state such as Prussia in the "Kaiserreich" or in the inter-war period which could dominate political decision making. While the system of fiscal equalization between the states (Finanzausgleich) needs a thorough overhauling, the basic structure of German-style federalism is certainly not endangered.[24] Economically, the fear seems to be just as misplaced: although certainly an industrial center before World War II, Berlin never dominated the German economy in the sense Paris dominates the French one; rather it was a kind of north-eastern counterweight to the industrial power concentrated in other regions like the Ruhr valley in the west, Saxony further south, Silesia in the south-east. It is likely to resume some of this prior function which should be welcome in view of the desperate lack of growth poles in the East. In this sense, the often-made comparison to Paris and the Île de France is beside the point; rather, Berlin may take over an economic role similar to the one of Rome in Italy, i.e. of a metropolis, which is lo-

[24] In this respect, recent concerns voiced in the Anglo-Saxon press seem to be exaggerated. See, for example, The Economist, "Germany's Struggle to Keep Federalism on the Road", 25 April 1992; and "Not as Grim as it Looks", 23 May 1992.

cated at the doorsteps of an economically backward region and, if anything, gives that region a growth impulse. However, just as Rome undermined neither the industrial vitality of the rich northern provinces of Piedmont and Lombardia, nor the dominance of Milan in trade and finance, so the resurgence of Berlin is very unlikely to develop such strong centripetal forces so as to degrade the rich west and south to shadows of their past power in industry and services.

To sum up, the new growth pattern to be expected after unification in the long run should not be viewed as distorting anything like a harmonious regional pattern of economic activity. Rather it removes some most artificial economic consequences of the division of Germany and of Europe.

e. Political Pragmatism

Due to German unification, the next 10 to 15 years will be a time of rather unideological, pragmatic policymaking. The reasons are basically economic ones: as described above, the 1990s and beyond will remain a period of an economic east/west-gap within Germany, i.e. of a clearly defined geographical imbalance. Typically in such times, the political cracks and rifts do not tend to coincide with party boundaries so that manifold implicit grand coalitions may become ever more frequent facts of political life, at least for those many "multidimensional" issues which concern federal, state, and possibly also local governments at the same time.

The trend towards pragmatism will be further supported by the small, but significant impact which the new German Länder are likely to have on the "balance of ideologies" in united Germany. While there is no doubt that the main orientation of major parties is basically determined in the western part of the country, the more subtle inner-party shifts and their long-term effects should not be underestimated: whereas the Christian Democratic Party (CDU/CSU) and the Liberals (The Free Democratic Party, FDP) have merged with eastern partners of a somewhat more left-wing tradition (less pro-business and more in favour of the welfare state and an active industrial policy), the Social Democratic Party (SPD) and the Greens have relatively conservative eastern partners with a strong background in the Protestant church and in so-called civil movements, but rather little attachment to traditional left-wing ideas. If these inner-party rifts will be overcome by some sort of compromise in the long run, then the ideological baselines of the parties will tend to move closer together and thus facilitate pragmatic multi-party cooperation. However, within the parties, the potential for conflict is likely to rise, especially within the CDU and the FDP, who have become parties with political strongholds in the east. The debate on the reform of the legal treatment of abortion, which saw the eastern CDU favouring a rather liberal practice and the western CDU by and large defending the status quo, may be a first foreboding of the future conflict potential.

Of course, a more general reason for the trend towards political pragmatism is that outright socialism, so far the main ideological ingredient of politics, has been largely discredited. As a consequence, socialist-leaning political forces like the Greens and the left wing of the SPD will more and more move away from their German-style anti-capitalist stance, which used to be a combination of anti-American pacifism, ecological radicalism, Fabian welfarism, and what may be called life-style libertarianism. While they will, of course, retain the traditional tinge of their political identity, they will become ready to allow for much more pragmatic solutions in all sorts of coalitions. To be sure, this tendency will be a straight continuation of trends that began in the 1980s and that seem to prevail in other advanced industrial countries as well.

While a fair dose of pragmatism may be welcome in view of the traditionally strong and often stubborn party adherence in German politics, the likely price to be paid for it should not be overlooked: with implicit grand coalitions looming behind many issues, the political resistance to the bribing of special interest groups may be reduced and the call for budgetary discipline may thus further weaken. Note that the trend for the large parties to cooperate will be further harnessed by the appearance of new parties and formations at the fringe of the political spectrum, notably at the right wing. In this respect, last year's election results in Baden-Württemberg and Schleswig-Holstein are a conspicuous case in point.

2. Demography and the Welfare State

Virtually the whole industrial world will experience a quite dramatic aging of its population in the coming decades. This will have far-reaching consequences for the financing and the structure of the welfare state, since it is likely to entail a sharp rise of the number of retired people relative to the active labour force. As demographic forecasts and scenarios tend to be somewhat easier to make and somewhat more reliable than forecasts in other fields in the social and economic sciences, we shall first give a brief quantitative sketch of what the demographic future will look like for the EC countries in general and for Germany in particular. We then draw some more tentative conclusions as to what all this means for the future of the welfare state.

a. Facts and Forecasts

The aging of the population is already well underway in all of the EC countries; it will accelerate considerably until 2010, culminating at about 2030–2040 when the baby boom generation of 1960–1975 finally reaches the retirement age. The reasons for this trend may be interpreted both as sociological and economic: sociological in the sense that they go back to a sweeping change of value systems towards a more radical individualism that is less ready to sacrifice personal ambitions and career prospects for child care and family life; economic in the sense that this value change typically evolves in industrialized countries with higher income levels and some sort of social safety net that helps to substitute formal institutions of health and old age insurance for the more traditional intergenerational support within the family.

The marked decline in fertility rates[25] in all of the EC countries, which began in the north (Germany, Denmark) and then spread to the south (Italy, Spain, Greece) has levelled off in recent years. In some of the northern countries, there are even signs of a moderate recovery that is believed to be not only a short-run phenomenon. Nevertheless, a future rise in fertility rates in the EC up to or even above the replacement ratio seems to be extremely unlikely. Nor will immigration be powerful enough to turn around this trend: for immigrants (or, more precisely, immigrant women of childbearing age) to compensate for the domestic "birth deficit" in the Community as a whole would require an annual net influx of migrants in the order of at least 5 million.[26] This would probably overstretch the absorption capacity of the EC countries, as it would imply a total of 50 million immigrants in a decade, i.e. about 15 per cent of the Community's present total population.

Following estimates by EUROSTAT that are based on national forecasts under slightly differing assumptions (see Table 3, which excludes East/eastern Germany), the "age burden"[27] of the Community, which stood at 21 per cent at the beginning of 1990, will have increased to 27 per cent by 2010 and to 31 per cent by 2020. The "child burden"[28] may decline from 27 per cent (1990) to 24 per cent in 2010 and 23 per cent in 2020. In addition, mortality rates are expected to fall further throughout the Community, so that the 80 and above age group will experience by far the highest growth

[25] Net reproduction rate: a value of 1 corresponds exactly to a stable population size in the long-run steady state.

[26] Assuming an age and sex structure for migrants as prevailed for ethnic Germans from CIS republics in recent years.

[27] Defined as the number of people 65 and above age group divided by the number of people 15–64 age group.

[28] Defined as the number of people 0–14 age group divided by the number of people 15–64 age group.

Table 3 — Demographic Trends in the EC and in Western Germany, 1990–2020[a]

	1.1.1990		2000		2010		2020	
	EUR12	DWEST	EUR12	DWEST	EUR12	DWEST	EUR12	DWEST
Age groups (years)	million							
0–14	59.6	9.44	58.2	10.36	53.2	8.35	48.4	7.60
15–64	220.2	43.63	221.6	42.93	220.2	41.20	211.1	38.20
15–29	76.8	14.41	64.1	10.12	59.5	10.77	56.7	9.67
50–64	55.1	11.76	58.3	12.54	64.9	12.75	72.0	14.70
≥ 65	47.2	9.61	54.2	11.01	58.9	12.75	65.0	13.02
≥ 80	11.0	2.39	11.9	2.44	15.4	3.07	17.0	3.70
Total population	327.0	62.68	334.0	64.30	332.5	62.30	324.5	58.82
	per cent							
Child burden[b]								
0–14	27.1	21.6	26.3	24.1	24.3	20.3	23.0	19.9
Age burden[b]								
≥ 65	21.4	22.0	24.5	25.6	26.7	30.9	30.8	34.1
≥ 80	5.0	5.5	5.4	5.7	7.0	7.5	8.1	9.7
Total burden[c]	48.5	43.6	50.8	49.7	51.0	51.2	53.8	54.0
Dejuvenation and aging of the potentially active population[d]								
15–29	34.9	33.0	28.9	23.6	27.0	26.1	26.9	25.3
50–64	25.0	27.0	26.3	29.2	29.5	30.9	34.1	38.5

[a]For Germany (western) a constant birth rate, a further increase in life expectancy and a cumulative net immigration of 2.84 mil. (including immigration from eastern Germany) from 1990–2014 (thereafter 0) has been assumed. — [b]As per cent of age group 15–64. — [c]Child + age. — [d]As per cent of age group 15–64.

Source: EUROSTAT, Demographic Statistics 1991. Luxembourg 1991; own calculations.

rates. All this has to be seen against the background of a general "dejuvenation" of the active population, whose average age will increase considerably.

As to the situation in Germany, one has to make an explicit distinction between the western and the eastern part of the country. The population in the western part of the country is clearly the most aged in the Community, and this should remain so at least until 2015–2020.

The net reproduction rate in the west showed by far the sharpest decline in the EC countries, from 1.18 in 1965 to a low of 0.60 in 1985; thereafter it rose gradually to an estimated 0.69 in 1991. In a quite realistic — though maybe somewhat optimistic — scenario, we expect this slow rise to continue, so that in 2010 the fertility rate in the west may approach 0.75. This is based on the assumption that the future will offer considerably more flexible working arrangements, enabling young couples to combine their professional careers with the raising of children in a way that requires fewer personal sacrifices (especially for women) than in the past. Sharper future increases in net reproduction rates could only be imaginable if there were a real breakthrough in changing the present tax and transfer system in favour of families with children. However, this seems to be less likely to happen, the longer the population continues to age, as the ever-increasing share of the elderly in the total electorate will tend to resist any such changes.

In the eastern part of the country, the age structure of the population is somewhat more favourable to the financing of old age pensions than in the west because fertility rates in the former GDR were considerably higher (0.80 in 1988) as a result of the strictly pronatalist policy of the communist government in the last two decades. At the same time, an almost comprehensive system for baby and child care provided the basis for reaching and retaining very high female participation in the labour force. After the fall of the Iron Curtain, in particular after the unification of East and West Germany, the net reproduction rate in the east dropped dramatically to less than 0.45 in 1991, with the number of marriages halving from 1990 to 1991 alone. A fall of nearly 50 per cent in the birth rate in less than five years is an altogether unique event in German demographic history; it even exceeds by far the respective decline observed in the German "Reich" during the Great Depression in 1929–1932. Apparently, the uncertain future prospects, especially in the labour market and in housing, which are the consequences of the abrupt change from a command system to a market economy, induced the majority of young couples to postpone child birth until the economic outlook turns more favourable.

Provided that labour market prospects in the east improve considerably from the end of 1992 onwards, we expect the fertility rate in the east to recover by 1993–1994. In numerical terms, we assume the eastern fertility rate to move up from 0.5, the rough average for the period 1990–1994, to nearly 0.9 in 1995–1999. Thereafter, i.e. when the births postponed in 1990–1994 are partly recouped, the fertility rate in the east might fall again and stabilize at around 0.7 from the year 2000 onwards. This is considerably below the level under the socialist regime because its pronatalist policy will find no adequate substitute under market conditions.

Taking a weighted average of the fertility rates for the east and the west yields an aggregate net reproduction rate for united Germany, though admittedly a rather tentative one: it is expected to fall from 0.69 (1989) to 0.64 (1991–1992), then to rise to 0.77 in the period 1995–1999, before it stabilizes at a level of about 0.74 beyond the year 2000 (more than one fifth above the western minimum arrived at in 1985).[29] This scenario has basically two implications:

(1) Since the fertility rate for total Germany will remain far below the replacement rate, the German population — barring immigration — will shrink, with rates increasing after the year 2000. The aging of the general population and of the labour force will accelerate considerably. According to an independent estimate of the Deutsches Institut für Wirtschaftsforschung (DIW) (see Table 4) the age burden in united Germany could increase by as much as 60 per cent from 1989 to 2020.

(2) The dramatic change in the birth rate in the east will be felt about 15–20 years later in the eastern German labour market: around 2010 there should be an extreme trough, around 2015 a very pronounced maximum of new entrants. A greater stability in the inflow into the domestic labour supply of the east will not be regained before 2020.

More comprehensive demographic forecasts for united Germany must be interpreted with great caution, since they involve the merging of separate scenarios for the two parts of the country with a quite different record to be expected.[30] One such forecast has been prepared by the Institut für Arbeitsmarkt- und Berufsforschung (IAB) of the Federal Labour Office. Some selected results from this forecast are shown in Table 4.[31]

Under the assumption of a constant fertility rate and a cumulative net immigration of 4.55 million by 2010 — consisting of 1.85 million ethnic Germans predominantly from CIS countries,

[29] Recently, the results of the seventh coordinated (between the Statistisches Bundesamt and the statistical offices of the "Länder") population forecast for united Germany have become available. As to the net reproduction rate, it takes a significantly more pessimistic view: 0.67, e.g. even somewhat below actual figures, for the west, and a future adjustment to the same figure in the east.

[30] This applies also to the seventh coordinated population forecast recently published by the Statistisches Bundesamt (see footnote 29).

[31] The results obtained by the Institut für Arbeitsmarkt- und Berufsforschung (IAB) are very much in line with the ones of the seventh coordinated population forecast (see also footnote 29), since the crucial assumptions underlying both forecasts are nearly identical.

Table 4 — Demographic Trends in United Germany and in Eastern Germany, 1990 –2020

	1990		2000		2010		2020	
	million	per cent	million	per cent	million	per cent	million	per cent
United Germany								
Total population[a]	79.47	100.0	81.80	100.0	80.54	100.0	76.43	100.0
Potentially active (age 15–75)	61.03	76.8	62.90	76.9	62.98	78.2	58.85	77.0
Inactive (age 0–14 and > 75)	18.44	23.2	18.90	23.1	17.56	21.8	17.58	23.0
Estimated labour supply[a,b]	41.06		40.88		41.40		38.19	
As per cent of age 15–75		67.3		65.0		65.7		64.9
Age burden[c] (age ≥ 60 as per cent of age 20–59)		35.2[d]		42.2		47.8		55.6
Eastern Germany								
Total Population[e]	16.25	100.0	15.51	100.0	15.30	100.0	14.50	100.0
Age 0–14	3.17	19.5	2.51	16.2	2.10	13.7	1.91	13.2
Age 15–64	10.92	67.2	10.76	69.4	10.48	68.5	9.73	67.1
Age ≥ 65	2.16	13.3	2.24	14.4	2.72	17.8	2.86	19.7
Estimated labour supply[e,f]	9.40		8.22		8.25		7.51	
As per cent of age 15–64		86.1		76.4		78.7		77.2
Dejuvenation and aging of the estimated labour supply[e,f]								
Age 15–29 as per cent of total supply		31.0		24.8		25.3		20.2
Age ≥ 50 as per cent of total supply		24.3		20.9		25.3		30.4

[a]Forecast of the Institut für Arbeitsmarkt- und Berufsforschung (IAB) of the Bundesanstalt für Arbeit under the assumption of constant fertility rates, further declining death rates and a cumulative net immigration of 4.6 mil. from 1991–2010. — [b]IAB forecast under the same assumptions as referred to in footnote a and in addition by postulating a moderate increase in labour participation ratios in western Germany (eastern Germany: see under footnote f below). — [c]Estimated by the Deutsches Institut für Wirtschaftsforschung (DIW), Berlin, for 2000–2020 on the basis of calculations of the Statistisches Bundesamt for 1989. — [d]1989. — [e]IAB forecast under the condition that fertility and mortality rates in eastern Germany will adjust to the ones in western Germany, and that from 1991–1995 there is a net emigration from the east (mainly to the west) of 205,000 (1996–2010: net immigration into the east (mainly from foreign countries) of 477,000). — [f]The until 1989 extremely high labour participation rates in the east are assumed to adjust to the much lower rates of the west especially in the case of married women.

Source: Calculated according to information obtained from the Institut für Arbeitsmarkt- und Berufsforschung of the Bundesanstalt für Arbeit, Mitteilungen aus der Arbeitsmarkt- und Berufsforschung, Nr. 4, Stuttgart, April 1991; Statistisches Bundesamt, Statistisches Jahrbuch. Wiesbaden 1991.

1.62 million asylum seekers, and 1.08 million other foreigners — but no further net immigration thereafter, population in total Germany would increase moderately from 79.5 million (1990) to 81.8 million by 2000. Beyond that year, total population would decline. Before 2010 this decline would only be marginal (declining to 80.5 million), as immigration would partly compensate for the domestic population shrinkage; thereafter, due to the assumed absence of further net immigration, the decline would accelerate (declining to 76.4 million by 2020).

The estimated labour force more or less tracks the path of the population: a near-stagnation at about 41 million by 2010, thereafter a shrinkage to 38.2 million in 2020. To illustrate the vigour of the domestic demographic contraction process, one might alternatively think of a no-immigration scenario (all other assumptions about birth and death rates remaining unchanged): in that case, the total population in Germany would decline from 79.5 million (1990) to 78.0 million in 2000, 74.6 million in 2010 and 70.1 million in 2020.

In view of these prospects, the crucial question of the coming decades for united Germany in the field of demography will be to what extent the country will accommodate the consequences of the aging and the shrinking of the domestic population by allowing immigration. In the past, official Germany has firmly denied that it is an immigration country. As the recent political discussion with respect to the asylum problem shows, one may expect this to change under the combined pressures of the dwindling domestic population and the strong demand for immigration from outside (ethnic Germans and asylum seekers from the CIS, migrant labour from eastern Europe etc.).

b. Implications for the Welfare State

It is quite safe to predict that the aging of the German population will lead to severe financial problems for the social security system. Above all, the compulsory old age insurance, which is based on the pay-as-you-go principle, is heading for troubled times: so far, benefits have been more or less indexed to wage growth, with a routine parliamentary decision legally enforcing the annual increases. As described above, the ratio between the number of retired people and the labour force will almost certainly rise and so will the percentage share of the gross wage that will have to be devoted to payroll taxes unless there is a thorough structural reform of the system.

In view of these rather bleak long-term prospects of the pay-as-you-go system, some reform measures were decided upon in 1989. Beginning in 1992, the benefits are indexed to wages net of payroll and wage income tax. This means that old age benefits after a complete "working life" (defined as 45 years) with average wage income are fixed at about 68 per cent of the average take-home pay of the employees. Further, the retirement age will be raised gradually in the future. Beginning in 2001, the standard retirement age — at present between 60–65 — is to be raised to 65 in 2017. In addition, there will be more leeway for the individual to choose his/her retirement age on an actuarially fair basis.

According to the projections of the government for a 15 years' period,[32] the revenues will suffice to cover the expenditures for the retirees, survivors, disabled etc., if the payroll tax rate (17.7 per cent in 1992 with half being paid by the employer and half by the employee) is raised to 20.7 per cent in 2005 and if the federal government's subsidy (amounting to about 20 per cent of total expenditures of the old age insurance system in 1992) is raised in line with the increase of gross wages and the rise of the payroll tax rate, i.e. in line with the contributions of employees and employers. To be sure, these projections are based on rather conservative forecasts of immigration; assuming a higher number of immigrants, the respective tax rate for the year 2005 would be somewhat lower, but still higher than at present. However, the projections do not include any negative effects of an increasing payroll tax and thus of a rising wedge between the consumer wage (take-home pay) and the producer wage (gross remuneration) on labour supply and labour demand which may aggravate the problem.

The compulsory health insurance (covering about 90 per cent of the population) will face problems similar to those of the old age pension system. The problems might be even somewhat more severe because the share of the very old (people aged 80 or more), which is of course a top-risk group, will go up markedly.[33] Hence, the payroll tax rate for compulsory health insurance (12.6 per cent in 1992 with half being paid by the employer and by the employee, respectively) is about to rise considerably in line with the aging process if no thorough going policy reform takes place. The Health Reform Act of 1988, which was a most painstaking uphill struggle in the political arena, did not entail any lasting effect for the most important kinds of health expenditures; in addition, the very important hospital sector was excluded from the reform initiatives. Without reform measures the health payroll tax rate is expected to rise to at least 15 per cent within a 10 or 15 years' period. The most recent Health Reform Act of December 1992 might change the picture somewhat.

---

[32] Deutscher Bundestag, Bericht der Bundesregierung über die gesetzlichen Rentenversicherungen (Rentenanpassungsbericht 1991), 12. Wahlperiode, Drucksache 12/1841. Bonn 1991.

[33] Sachverständigenrat für die Konzertierte Aktion im Gesundheitswesen, Jahresgutachten 1991: Das Gesundheitswesen im vereinten Deutschland. Baden-Baden 1991.

All in all, the social security system is shaping up to a first rate challenge that bears the risk of running out of control. The question of how to cope with the financial difficulties associated with population aging will remain on the agenda of the economic policy debate for decades to come, despite the recent reform steps taken. The relevant options are not difficult to detect:

(i) Policy might react by simply raising further the rate of payroll taxes for the old age and the health insurance system. This option has the obvious drawback that it may lead to more wage pressure if workers and unions do not accept an equivalent cut of their take-home pay, but rather insist on recouping the real income loss by a rise of the gross wage. The concomitant increase in labour costs might then lead to a rise of equilibrium unemployment, thus to higher payroll taxation for unemployment insurance and to a lower employment and income base to tax in the future. Under unfavourable macroeconomic circumstances, a genuine payroll tax-wage spiral may set in, which undermines the basis of the welfare system. This is why some further cautious increases may be politically envisaged, but a great leap forward to a new dimension of payroll tax rates looks rather unlikely.

(ii) Obvious alternative policy options are a further rise of the retirement age and/or cuts in benefits. Within the limits of what an inertial popular consensus on social security deems as reasonable, these options will be used. However, the limits of change are rather narrow, not least because any more drastic measure would be highly unpopular in view of the growing share of the elderly in the voting population. Therefore, it is likely that only minor reductions of the benefit levels will be discussed and finally enacted in the coming 10–15 years.

(iii) Most probably, a different option will be on top of the policy agenda, namely a change of the immigration laws. In view of the demographic challenges of a shrinking domestic labour force, it will be increasingly realized by the public at large that a more liberal immigration policy may help alleviate pressure from the social security system and may keep at bay the need for overhauling the otherwise popular pay-as-you-go model of social security. To ever more people and voters, the option of extending the inter-generational contract to a new cohort of young people from abroad will look increasingly attractive, not least in the light of emerging labour scarcities. Thus, the question of reforming the social security system will more and more blend with the broader issue of making Germany an immigration country, with a carefully designed policy of screening potential entrants to maximize their positive external benefits in the form of taxes and social security contributions.

Apart from its detrimental effects on the financing of the social security system, the unfavourable demographic trend will certainly lead to a rise of expenditures for existing tax-financed social services. Apart from the medical needs of the very elderly, there will be a growing demand for more long-term care facilities, both public and private ones. Given a continued trend away from intra-family care for the elderly, which is reinforced by the demographically caused shrinking of intra-family ties, an ever growing number of people will need help from outside institutions. This trend is reinforced by the growing participation rates of the female labour force, which reduce the individual leisure time to be used for care of the parent generation. It is widely expected that the government will supply some kind of tax-financed public help to alleviate this problem. It is also likely that, in a few years' or even months' time, some sort of compulsory insurance for the care of the elderly will be added to the social security system. According to most recent announcements by the government any additional expenditures are to be financed by equivalent cuts of existing benefits; given the outcry in the public in view of the proposal of reducing the rather generous sick leave benefits (since 1970: 100 per cent of wages, beginning with the first day of illness), however, the government may in fact refrain from making its announcements come true.

3. Labour Markets and Collective Bargaining

a. Trends and Developments

In speculating about the future features of the German labour market, one should sharply distinguish between two types of tendencies, namely those emanating from "exogenous" trends common to more or less all advanced industrial societies and those arising from the peculiar German situation of a unified country covering two very different economies.

Three general trends are likely to continue in an unabated manner. First, due to the combined effect of productivity growth, shifts of private demand at rising income levels and a changing division of labour, employment in the tertiary sector — notably in private services — will grow faster than in industry. By international standards, Germany will continue to have a relatively large industrial sector due to its traditional pattern of intersectoral specialization, but the employment share of services will grow more or less as it did in the past two decades, even if there will be no severe supply shocks hitting industry as the two oil price hikes in 1973/74 and 1979/80.

Second, female labour force participation will keep growing due to sociological trends in favour of a more balanced division of labour between the two sexes. In this respect, Germany still lags somewhat behind most other advanced countries with comparable income levels and one might expect this gap to narrow since other countries, notably in Scandinavia, have already reached an almost equal employment participation of men and women.

Third, there will be a continued trend towards more flexible working time including part-time work caused by a combination of three factors, namely (i) structural change from industry to modern services which have a less rigid time-bound complementarity of capital and labour in production, (ii) the increasing labour force participation of women who are forced to combine household duties and employment, and (iii) a sociological trend towards more individualized working relations, which appears to be characteristic of advanced societies at high levels of income, and a strong preference of people for leisure and mixed forms of work and leisure.

These trends are likely to be overlapped by quite different forces originating in the economic unification of Germany. At present, the east goes through a drastic transformation process that involves an abrupt cut of industrial employment, with the large female industrial work force, which had extremely high socialist-type participation rates, being particularly hard hit. Optimistically speaking, a forceful reindustrialization may set in by the mid-1990s — somewhat contrary to the long-run trend — but it is unlikely to be the female labour force which will profit most from it. Rather, one might expect the participation rate of women to drop permanently to the standard of the west. In any case, economic policy makers are likely to be obsessed with the aim of rebuilding the industrial base in the east, with the growth of the service sector remaining a side issue. Probably for a whole decade, this will make the policy debate resemble the one in the early 1950s when overcoming capital shortage unemployment due to the influx of refugees and war-time destruction was the focus of policy interest.

Whether all this leads to a further tightening of labour markets in the west and to a sustained improvement, i.e. something like a return to full employment in the east will depend on at least four sets of factors, namely (i) on the growth of the labour supply, (ii) on the economic success of the large-scale subsidization of the east, (iii) on labour market deregulation, and (iv) on union behaviour.

(i) Labour supply: Demographic changes will almost certainly pull towards a shrinking labour supply, a trend which will only be mitigated, but not neutralized by rising female participation rates. In this respect, united Germany in the 1980s and beyond (both west and east) will have features of West Germany in the 1960s. However, there will be growing immigration pressures from Eastern European countries, which might take a similar "safety valve" function in industrial boom periods as the "guest workers" from southern Europe in the 1960s. Whether they can serve as anything like close substitutes for domestic labour — especially the skilled part of it — is doubtful so that, at least in the west, a secular tightening of labour markets might be felt from the mid-1990s (incidentally leading to large-scale internal east-west migration).

(ii) Public transfers to the east: By the mid-1990s, the vast public investments in the east carried out with taxpayers' money from the west will certainly have removed the worst infrastructure bottlenecks, both as to the physical and the administrative infrastructure. Whether the massive subsidization of private investment in the east will be successful enough to close the "capital gap" of post-socialism is much more doubtful. It will crucially depend on how labour costs develop which, in turn, will depend on collective bargaining.

(iii) Labour market deregulation: All over the 1980s, the deregulation of labour markets has been a persistent theme of the policy debate on how to reduce unemployment, with the only tangible political result being a law in 1985 which generally allows fixed-term contracts up to two years and which is now set to expire by 1995. With labour markets tightening again in the west by the late 1980s, the discussion finally died down, and it is unlikely to be revived again in the 1990s, despite the mass unemployment in the east[34] and despite a general trend towards an individualization of labour contracts. The main reason is that the debate had been embedded in the larger discussion on deregulation, which was a big topic in the poor growth climate of the early 1980s but which is simply eclipsed by the vast transformation problems of post-socialist Eastern Europe and its integration in the world economy by the 1990s. Yet, while it is unlikely that there will be a new legal offensive in the field of labour market deregulation, there may well be some de facto deregulation in segments of the labour market due to a rising share of immigrants who are ready to work at conditions below the contractually fixed minima (see Section I.2 above).

(iv) Union behaviour: It is, of course, extremely difficult to predict how unions will react to the set of exogenous challenges emanating on the labour market and beyond. At best, some major informed guesses are possible, and we shall try to make them in the following subsection.

b. The Future of Unionism

Given the above mentioned trends of structural change towards service employment and flexibility of employment conditions, unions will in general find themselves on the defensive. In the long run, they will face a strategic choice: either they stick to their traditional norms of horizontal equity and tight union control of working conditions so as to preserve their identity — thereby running the risk of becoming increasingly unpopular with their own clientele — or they adjust to the new conditions and allow for more flexible, individualized agreements — thereby risking sacrificing their own identity which, at least in the eyes of the public, heavily depends on ideas of collective standardization. In practice, the unions are likely to strike a compromise line as they did in the past, with public rhetoric and the broad outline of their stance remaining "conservative", but with some flexibility sprinkled into collective agreements as to working time and conditions, which helps to accommodate the new trends. As in the last decade, this will be a very uneasy position somewhere between the Scylla of degenerating into a mere service organization of employees, and the Carybdis of losing the contact to the new generation of more relaxed young employees. All this adds up to a position of vulnerability of the union movement with no prospect for a reversal of the gradually falling union density rates in the 1980s and the 1990s.

Whether this will lead on average to more or to less militancy in wage bargaining is open to speculation: more militancy may be due to the fact that unions tend to show more muscle in one field (remuneration) if other fields begin to slip out of their grip (working time etc.). This view is consistent

[34] Those instances, rare anyway, where labour market regulations are not stringently applied to eastern Germany, are only temporary deviations in the transformation process and do not flag a reconsideration of the basic provisions.

with the off-hand observation that German unions were rather moderate in wage claims at times when they had important other aims on their agenda like codetermination in the early 1950s and the shortening of the working week all over the 1980s. By the late 1980s, the switches have been set towards the 35-hour week to be realized in the next few years; no comparably spectacular aim is in sight for the coming decade so that unions may focus again on their traditional main battlefield, that of wages. Other aims such as overhauling the structure of wages between ill-defined professional groups are presently discussed in union circles, but obviously, they will remain technical side issues.

On the other hand, it is hard to imagine unions to flex their muscles at a time which will basically have an anti-union tinge: after all, the only dramatic "wage revolution" in West German post-war history happened in the period 1969–1974, a time of growing union popularity, sharply rising union density rates and a union-friendly government which fostered a social democratic reform enthusiasm. Even if the federal government became again social democratic/liberal in 1994 or 1998, the very strong union influence of earlier times is unlikely to be repeated. A more realistic scenario seems to be that unions periodically step up wage demands in boom times, but do refrain from an ideologically fuelled massive redistribution from "capital" to "labour".

The only major macroeconomic trend which seems to work in favour of unions' aims and aspirations will be the demographic changes to be expected from the mid-1990s on, with successive waves of retirement leading to a drastic "exogenous" reduction of the domestic labour supply (see Section II.2 above). On closer inspection, however, even this trend will have double-edged consequences for the unions' strategy, since it is likely to require more internal wage differentiation. In the lower segments of the labour market, the ensuing shortages will be rather easily accommodated by attracting foreign workers or immigrants from Eastern Europe, Turkey, and maybe also increasingly — via France and Italy — from northern Africa. In the upper qualitative segments of the market, this will not be possible to the same extent so that structural disparities in scarcity between different types of labour, which already exist, will be further accentuated. Naturally, upwardly mobile skilled workers — mostly German ones — will profit most from these trends, and they will call for a more pronounced wage stratification between skilled and unskilled labour. As an important union clientele, they will put pressure on the union leadership to allow them to cash in their scarcity rent. In turn, this will push unions into another variant of their basic strategic dilemma: either they will give way to the internal demand for wage stratification and thus further erode their traditional reputation as representatives of the broad masses of (unskilled) blue-collar workers, or they will stick to an egalitarian philosophy and thus risk to appear as a defender of the rights of fringe groups, notably of immigrants and foreign labour. In many respects, these conflicts may resemble the dilemma of unions in the 1960s when the extreme shortage of skilled labour led to massive wage drift, i.e. to a much faster growth of actual earnings than of contractual minimum wages. It finally ended in a wage revolution with the union leadership bending to the call of the rank-and-file for more militancy. As argued above, however, such a gloomy outcome seems to be much less likely in the future simply because the unions' power base is gradually eroding for other reasons anyway.

The really big challenge to unions in the 1990s is a structural one, namely the transformation crisis in eastern Germany. To the great surprise of many observers — especially foreign ones — pilot wage agreements in eastern Germany settled for an equalization of contractual wages in major industries between west and east by 1994. There are basically two reasons for these altogether unreasonable terms: first, the employers' side was represented by heavily subsidized, not yet privatized firms which faced a very soft budget constraint and thus could effectively externalize the future costs of the agreements. Second, German unions tend to take it as an utmost priority to avoid anything like a long-term regional differentiation of wages which could violate the maxim "equal pay for equal work". In fact, the inter-regional wage structure turned out rigid in earlier periods of crisis as well, even if the incidence of structural crisis was heavily concentrated in specific regions like the Ruhr valley or the Saar. In this sense, unions took the transformation in the east as another regional problem not to be accommodated by regional wage restraint.

Clearly, it will be of crucial importance for the prospects of the eastern German labour market whether this misguided wage policy will be reversed or not. If not, all the burden of creating incentives for private investment in the east will continue to lay on public subsidization which, due to unprecedented fiscal constraints, can hardly do the job alone. The danger will then rise that eastern Germany will be stuck with a dramatically higher equilibrium unemployment rate than the west. The big question of German labour markets in the 1990s will be whether such a disastrous "dualization" of labour markets into a full employment western and a long-term unemployment eastern part can be avoided (for details on these prospects, see Section II.1 above). Probably the only way is to renegotiate wage contracts for the east; whether unions will be ready to reopen negotiations — which would be unique in the history of German collective bargaining — depends on the sheer extent of the crisis and, most importantly, on the prospective fiscal consolidation of the federal budget which may cut heavily into the transfers to the east. At any rate, an uncompromising stance of the unions might become very unpopular in view of a deepening crisis and mounting public pressures, both in the west and in the east. In the west, the average man in the street and the average union member may begin to realize that his/her tax bill is in fact a direct function of the eastern wage level. In the east, the worker may increasingly acknowledge the fact that his/her market prospects depend heavily on a persistent wage differential between west and east.

From a more long-term perspective, German unification may amount to a very serious challenge to the unions' prominent role in society. After all, the eastern German population shares the anticollectivist attitude that now predominates in all the former communist countries in Central and Eastern Europe: since the union movement had been instrumentalized and thus thoroughly discredited by communist regimes — with Solidarnosc in Poland being the exception to the rule — people are very reluctant to join again any collective organization that pretends to further their individual interests. In fact, after experiencing an initial surge in membership right after German unification, unions presently complain about the great difficulty of recruiting new members in the east, a difficulty which is not only due to high unemployment, but also to a general scepticism vis-à-vis any form of collectivist tutelage. Even if labour markets in the east tighten up in due course, this scepticism is likely to remain a characteristic feature of the eastern German labour force. In this respect, eastern Germany of the 1990s will resemble West Germany of the 1950s, when the so-called "sceptical generation", who had vivid memories of the Nazi-style collectivism, kept aloof from large-scale interest groups, with the unions facing very low popularity ratings and declining density rates.

III. Resources and Infrastructure

1. Energy and the Environment

Energy policy in united Germany faces two major challenges in the coming decades, namely (i) the opening of the energy market to unfettered competition in the wake of the completion of the EC common market, and (ii) the transformation of the decrepit eastern German energy sector into a modern power industry.

a. Energy and Environmental Policy in the EC and in Germany

Long-lasting effects on the energy sector in the Community are to be expected mainly from three major developments initiated or supported by the EC. These are (i) the completion of the European

Common Market taking effect on 1 January 1993; (ii) the introduction of a levy on energy consumption in order to reduce carbon dioxide — CO_2 — emissions; and (iii) the implementation of the European Energy Charter agreed upon in The Hague on 17 December 1991, by the large western industrial countries under the chairmanship of the EC with 14 successor states of the former Soviet Union.

Common Market in Energy

The common market of the European Community is conceived to take the form of an economic area without internal frontiers and border controls ensuring the free traffic of goods, persons, services, and capital. Naturally, the energy sector is not to be exempted from the thrust of liberalization; this means that current demarcation-, association-, and concession contracts, which guaranty a regional monopoly status to utilities and, thus, almost completely exclude them from the general competition rules in virtually all community countries, cannot be upheld.

Until now, the EC has passed three directives to intensify competitive forces in the energy markets: the council directive of 29 June 1990, concerning a community procedure to improve the transparency of gas and electricity prices charged to industrial users; and the two directives on the transits through transmission grids for electricity (29 October 1990) and for natural gas (31 May 1991) both aimed at encouraging interactions between national long distance grids. Moreover, proposals for abolishing the local supply monopolies are under scrutiny; similar proposals have been put forward by the Federal Deregulation Commission in Germany in early 1991.

In flat contradiction to the aim of a Common Market and to the rules of the GATT treaty are the protective measures persistently adopted by the German government on behalf of the domestic hard coal producers. On a rough estimate, subsidies paid amount to a total of about DM 11 billion in 1990 (see Table 2 in Section I.4 above). In contrast, the production and consumption of brown coal is not subsidized either in western or in eastern Germany (with the exception of land reclamation).

In the so-called (hard) "coal-round" — an agreement of the federal government with producers and the main consumers negotiated at the end of the year 1991 — a reduction of output from presently 70 million tons per year down to about 40 million tons a year has been envisaged until the end of the century. If this reduction will in fact materialize, it will reduce the amount of direct aid by nearly DM 4 billion, provided that the difference between the price for imported coal and coal from domestic production is not widening in the meantime. Even if this production and subsidy cut actually came about, Germany would still remain a highly protectionist country in energy markets.

Energy-Consumption Tax

An enormous adjustment pressure for the energy sector can be expected if current proposals on reducing the emissions of CO_2 — one of the major instruments of environmental policy to cope with the impending threat of global warming — by charging a levy on energy consumption in general and on fossil fuels at a special rate were to come into force. Since the federal government of Germany refrained from introducing such a scheme on its own, it is now up to the Community authorities to develop appropriate proposals and initiatives. The proposals envisage a combined energy/CO_2-levy (50 per cent energy-, 50 per cent CO_2-charge). The fiscal charge should actually start at US$ 3 per barrel, rising US$ 1 each year and reaching a final value of US$ 10 per barrel in the year 2000. Exemptions are only allowed for renewable energy resources and highly energy-intensive production processes.

If this proposal is executed in the present form, the use of brown coal will be charged with the highest rate as it involves a relatively high carbon content. In the last phase, the value of brown coal will be charged by an additional levy of 70 per cent (compared to 58 per cent for hard coal, 45 per cent for heavy fuels, and 34 per cent for natural gas). This would be a lethal blow for virtually all brown coal mining in eastern Germany. It seems realistic to expect that the federal government of Germany would try, for political reasons, to negotiate major (temporary) exceptions with respect to brown coal mining.

European Energy Charter
This Charter aims at promoting the cooperation between the western industrial countries and the successor states of the former Soviet Union in energy matters. A massive transfer of know-how and capital from the western countries into the decrepit, inefficient extraction and processing installations in the oil and gas sector of the former Soviet Union is proposed in exchange for energy supplies from there to western countries. In the short run, the charter may help stemming post-Soviet chaos in energy provision for the ex-communist countries themselves, with a specific focus on increasing security of nuclear power stations; any major nuclear accident may have devastating effects on the environment and economic and political life in the respective countries and may eventually induce mass migration. In the long run, the charter may lead to a basic reorientation of the European energy system, eventually reducing dependency on energy supplies from the OPEC area.

b. The Eastern German Energy Market and Environmental Targets

Energy policy in the former GDR put a high priority on self-sufficiency, with the highest possible use of brown coal as the only domestic energy resource in ample supply. Remaining energy supply gaps were closed almost completely through energy imports from the other former COMECON countries. Prices in the energy sector did not reflect the scarcity of fuel supply, but an inconsistent combination of other aims, in particular of social policy considerations which evoked a heavy subsidization of energy consumptions; roughly speaking, energy prices covered on average no more than a quarter of the production costs.

The "bias" towards coal can be seen in Table 5: in 1989 nearly 70 per cent of primary energy consumption in East Germany and almost 83 per cent of the energy input in the generation of electricity were derived from domestic brown coal. The heavy concentration on brown coal and the disregard of noxious emissions (particularly of sulphur dioxide) made the industrial centers of East Germany one of the most polluted regions in Europe. However, due to a sharp decline of industrial production (see Table 5), there has been a substantial reduction of toxic emissions. For recent installations of power plants, the high western standards of security and regulations of environmental protection are applicable since 1 July 1990 in eastern Germany. Older installations yet in operation are to meet the regular emission standards until 30 June 1996 through additional technical improvements or have to terminate operating until then.

As to the economic part of the transformation, the eastern German energy sector was not exposed to genuine competition; it rather became subject to the same far-reaching regulations restricting competition in the western part of the country. Privatization in general went on fast, but has recently been grounded to a halt due to a number of serious legal conflicts between the potential new owners — mostly large western German utilities — and local governments.[35] This dispute seems to be settled by a compromise between the conflicting parties in December 1992, still suspending, however, the approach by all complainant local governments, meanwhile 168 by number.

2. Transport

a. General Trends in Europe

The main factor shaping the future development of transport infrastructure networks throughout Europe is a growing demand for goods and passenger transport services in a high-mobility environ-

[35] For a detailed stocktaking and evaluation, see Axel D. Neu, Anpassungsprozesse in der ostdeutschen Energiewirtschaft — Analyse und Bewertung. Institut für Weltwirtschaft, Kiel Discussion Papers, 179/180, February 1992.

Table 5 — Structure of Energy Consumption in the Two Germanies, 1970–1990[a]

	Old territories (FRG)				New territories (GDR)			
	1970	1980	1989	1990	1970	1980	1989	1990
	petajoule							
Primary energy consumption (PEC)	9,870	11,437	11,219	11,489	3,050	3,566	3,756	3,291
	per cent							
of which								
oil	53.1	47.6	40.0	41.0	13.5	17.3	13.9	15.8
hard coal	28.8	19.8	19.2	18.9	9.9	6.7	4.2	4.2
brown coal	9.1	10.0	8.5	8.2	75.2	62.8	68.5	68.7
natural gas	5.5	16.5	17.3	17.7	0.7	8.5	9.3	8.6
nuclear	0.6	3.7	12.6	12.0	0.2	4.0	3.7	1.9
hydro	2.5	1.9	1.4	1.2	0.4	0.6	0.3	0.7
others	0.4	0.5	1.0	1.0	0.1	0.1	0.1	0.1
	petajoule							
Final energy consumption (FEC)	6,751	7,529	7,223	7,412	1,921	2,265	2,274	2,012
	per cent							
of which								
industry	39.4	34.3	31.6	30.4	48.7	45.2	42.6	36.0
transport	17.1	22.1	27.5	28.2	11.1	9.9	10.7	14.3
residential	26.8	26.8	24.5	25.0	19.3	21.1	21.7	25.9
others (incl. military)	16.7	16.8	16.4	16.4	20.9	23.8	25.0	23.8
	gigajoule							
Key indicators								
PEC per capita	162.6	185.8	180.8	181.7	178.4	213.5	226.3	201.9
FEC per capita	111.3	122.3	116.4	117.2	112.3	135.7	137.0	123.4
	megawatt hours							
Electricity consumption per capita	4.12	6.08	7.11	7.09	3.98	6.00	7.22	6.27
	gigajoule							
Residential energy consumption per household	82.2	81.3	63.9	65.9	62.99	72.67	71.3	75.62

[a]FRG until 3 October 1990 and the former GDR.

Source: Bundesministerium für Wirtschaft (Hrsg.), Energie Daten '90. Entwicklung für die Bundesrepublik Deutschland. Bonn 1991; own calculations.

ment. Forecasts of rapidly rising traffic volumes are based upon the following prospective developments: (i) an accelerated economic growth due to the completion of the European Common Market, (ii) a still more intensive international and inter-regional division of labour in Europe (European Economic Space, liberalization in Eastern Europe), (iii) a more liberal regulatory framework for transport, and (iv) persistently high income elasticities of private car ownership and individual traffic (including tourism). The major economic trends which pull in the opposite direction, namely the slowdown of traffic volume growth caused by a decreasing share of manufacturing, and the substitution of physical traffic by telecommunication devices are generally expected to be not powerful enough to overcompensate the positive impulses.

On the supply side, adjustment of transport infrastructure networks to the increasing demand will crucially depend on (i) whether the legal framework for construction and provision of networks can be made more flexible by liberalization measures, (ii) whether user costs and charges can be made to take account of external costs (pollution, congestion) and external benefits (regional development effects), and (iii) whether there is a specific political preference towards certain transport modes and mobility in general.

b. The German Situation

The German transport network will be affected by all general trends mentioned above, the most important factors being the transformation process in Eastern Europe and, of course, German unification. Gradually, Germany is bound to regain its pre-war position at the crossroads of east-west and north-south intra-European traffic. Traffic volumes — especially in the east-west direction — are likely to increase sharply in the next two decades. In addition, and in response to the European Common Market programme, the rather rigid regulatory framework which is still in force in Germany will have been abolished to a large extent by 1994.[36]

A recent study commissioned by the Federal Minister of Transport has forecast a continuing growth of traffic up to the year 2010 (see Table 6). Between 1988 and 2010, total long-distance cargo transport performance (tonne kilometres, tkm) in united Germany is expected to rise by approximately 77 per cent, with the traffic on roads and waterways growing faster than that on rail. Note, however, that these aggregate figures disguise an important structural difference between the western and the eastern part of the country: in terms of expected growth rates, rail traffic surpasses road and waterway transport in the west whereas the opposite holds for the east. Here the dominant market share of the railway (Reichsbahn) will be driven down sharply in the next few years. Passenger road traffic will increase by about one third (passenger kilometres, pkm) up to 2010. The main driving force behind this expansion is the demand for private travel, both weekend and holiday, based on the trend towards a rising number of short holidays and on the pent-up demand for individual mobility in the east. By 2010, about two thirds of all passenger traffic will be due to private holiday travel.

Deregulation of prices and market access will have considerable impact on transport in Germany. It will do away with rents based on government-imposed constraints; as competition intensifies with more entrants coming onto the markets, there will be scope for price reductions. In the absence of restrictions on industrial carriage in road transport or on cabotage, ballast voyages can be avoided and lorries may be operated more efficiently. It has been estimated that by removing the tight of regulation of national German transport, prices for road transport may be lowered by as much as 25 per cent on average. In inland water transport, freight rates may even come down by up to 50 per cent. Separating operations from the infrastructure in the railway system and introducing an element of competition into the operations may also permit considerable productivity gains to be achieved which will enable the railways to adjust prices to those of competing modes of traffic. On the other hand, modal shifts away from road transport are not likely to happen on a large scale simply because the special affinities between many types of goods and road transport make it difficult to shift cargoes directly from road to inland vessel, or even to railways.

These changes will require far-reaching adjustments of the infrastructure if major congestions with negative consequences for economic growth in bottleneck regions are to be avoided. Even if railways will be enabled by more commercial revamping to regain market shares, and even if there will be additional scope for substituting coastal shipping for inland carriage, especially for long-distance traffic passing through Germany in transit, the main impact of demand will affect road transport. However, the provision of additional transport capacities does not necessarily involve new large-scale road or rail construction in western Germany; instead, attention is increasingly turned to a more efficient use of existing road and rail capacities, for example, by introducing "intelligent technical systems" of

[36] Exemptions are cabotage reservations and the harmonization of public levies on transport which lag behind the general liberalization trend.

Table 6 — Transport in Germany, 1988 and 2010

Transport modes	Long-distance cargo transport						Passenger transport		
	western Germany[a]			eastern and western Germany			eastern and western Germany		
	traffic performance		growth rate	traffic performance		growth rate	traffic performance		growth rate
	1988	2010		1988	2010		1988	2010	
	billion tkm		per cent	billion tkm		per cent	billion pkm		per cent
Road	111	182	64	122	238	95	734	946	29
Rail	65	132	103	125	194	55	62	87	40
Waterway	56	91	63	63	116	84	–	–	–
Air	–	–	–	–	–	–	14	35	150
Total	232	405	75	310	548	77	810	1068	32

[a]Excluding Berlin.

Source: Kessel & Partner, Güterverkehrsprognose 2010, Freiburg i.Br., July 1991; Intraplan Consult GmbH (ITP), Institut für angewandte Verkehrs- und Tourismusforschung (IVT), Personenverkehrsprognose 2010 für Deutschland. Munich, June 1991.

traffic flow management which allow for a much higher network capacity utilization than achieved at present. Additional investment in the road/rail terminal interface is needed to foster the evolution of a system of combined road/rail traffic, i.e. regular carriage of lorries via rail over long distances so as to restrain demand for road capacities and to bring about what may in effect amount to a modal shift.

To remove the most urgent infrastructure bottlenecks in eastern Germany, the federal government has recently drafted a special programme which comprises 17 high-priority infrastructure projects, among them various autobahn routes. At the same time, however, it is becoming increasingly difficult, especially in the more advanced western part of the country, to actually carry out new large-scale infrastructure projects. Such difficulties arise less from scarcity of public funds — a problem which could be mitigated by including private capital in the financing of new infrastructure; rather, they arise from a growing concern about traffic-related pollution costs and, more generally, from widely shared doubts on the desirability of continuing modal shifts towards road transport and individual traffic.

c. Policy: Consensus and Controversies

The public and economists jointly criticize the government for reacting too slowly and for taking only insufficient steps to cope with the emerging infrastructure bottlenecks and traffic-related environmental damage. It is also widely felt that the greater part of transport and infrastructure policy initiatives is lacking consistency.[37] Concerning the retarding elements in the process of administrative approval, the German Bundestag has passed a law in 1991 which aims to speed up this process; the law focuses on the removal of the current obstacles to infrastructure building mainly in eastern Germany. The introduction of road (way) pricing is not considered.

Whereas the basic aims of future transport policy in Germany — to solve congestion and environmental problems — seem to be generally accepted, the means to reach these aims are debated controversially by the general public. On the one hand, there is a strong tendency to use infrastructure policy for bringing about modal shifts away from road transport. On the other hand, transport economists in general favour policies that internalize pollution costs and congestion through the price mechanism.

[37] A case in point is the Transrapid project which was inaugurated and largely financed by the Federal Ministry of Research and Technology. To prove its technical viability on a large scale would only be possible with new subsidies by the federal government and lead towards a traffic diversion from the high-speed Bundesbahn trains. Nevertheless, it is likely that public funds will be forthcoming.

The public seems to be far away from accepting a policy stance in matters of transport that is based on economic principles: environmentalists tend to object to any growth in traffic even if the price system effectively internalize pollution; in turn, the electorate would object to a severe price tag on individual mobility, their attitude reflecting that congestion problems on the roads are in fact caused to a large extent by private cars rather than by lorries. Most probably, transport policy will strike a rather pragmatic compromise: some levies will be combined with new infrastructure projects to provide the required capacities, accompanied by some administratively induced modal shifts in favour of rail and water transport and of public commuting facilities.[38]

d. Supranational Matter: The Role of the EC

Certain problems of infrastructure management may require handling on a community level. A case in point are rules for calculating road, railway and waterway user costs, of defining corresponding levies etc. While EC guidelines regulating the major matters of user charging may be necessary, a regional differentiation of taxation and of levies according to actual resource consumption should remain possible. In devising solutions, the territorial principle should be applied throughout so that no competitor may draw an advantage from not paying for the roads, railways or waterways he/she uses in a foreign country. It is also relevant that user-cost charges should be levied in proportion to the actual mileage (allowing for peak-load pricing), not on a lump-sum basis. Also to be handled by the EC is the problem of emissions of noxious substances from cars. Since the territorial principle does not apply in the case of emissions, these being of a transnational nature, it seems appropriate to define common emission standards for cars at the Community level.

As far as current plans for European transport networks are concerned, a specific planning and administrative effort at EC level does not seem to be warranted although the Commission should encourage the prevalent endeavours of member states to increase network compatibility in their own competence. This rather sceptical view of the role of the Commission in infrastructure policy extends to the provisions concerning the newly created cohesion fund in the Maastricht Treaty on the Political Union.

[38] Note that, in urban areas with particularly severe congestion problems, the balance may be tipped in favour of relatively high charges. At present, several models are being discussed ranging from high parking charges to compulsory purchase of tickets for public transport as a condition for entering the city area by private car, and to outright closure of that area to private traffic.