Inquiry: The University of Arkansas Undergraduate Research Journal

Volume 8 Article 9

Fall 2007

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WHAT IS AILING THE GERMAN ECONOMY? A CRITICAL ANALYSIS OF GERMAN SOCIAL MARKET ECONOMICS

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Abstract

This paper offers a narrative historical description of the German Social Market Economy, from its inception following World War II, up to the recent Agenda 2010 reforms enacted under the administration of Chancellor Gerhard Schröder. It is the purpose of this work to explore why the German Social Market System enjoyed such a high degree of success in its early years, and which flaws might be causing the chronic problems of low growth and high unemployment that have plagued Germany more recently. In particular, the paper argues that a high-cost and highly inflexible labor market resulting from Germany's system of autonomous collective wage bargaining may be stymieing business growth and scaring away foreign investment.

Introduction

The health of the German economy is a topic of special concern, not only for the people and politicians of Germany, but also for all of the member countries of the European Union. As the largest economy in Europe, Germany's economic strength has significant influence on the well-being of its neighbors. Since the mid-1970s, the German economy has suffered under struggling gross domestic product (GDP) growth rates, with persistently high unemployment figures. At the end of 2006, eight percent of German workers were unemployed, with unemployment rates in areas of the East as high as 20%. Since reunification, Germany's real GDP growth rate has averaged a meager 1.8% (OECD Statistics 2007). Economists and politicians alike point to the severe weakness of the eastern German economy as a major cause for the current situation. The cost of unification is estimated to have exceeded €1.5 trillion, and every year the German government pumps €70 to €80 billion into the region, costs which consume four percent of the GDP annually (Economist May 8, 2004). The high unemployment in the area has spurred many of the young and skilled workers of the East to migrate elsewhere, resulting in a dramatic aging of this population and a loss in creative force. Apart from the problem of the East, many experts point to an inflexible labor market as a major cause for high unemployment numbers and see heavy bureaucratic regulations imposed by the German government as stymieing new business growth. Furthermore, weaknesses such as high labor costs, poor worker flexibility, a heavy tax burden, and high energy costs are all cited as detractors which are keeping foreign and domestic investors from setting up production facilities within Germany (Economist Aug. 20 2005).

In order to better understand the current problems facing Germany's economy, it is useful to consider the history of Germany's modern political and economic system. Following the defeat of Germany in 1945, the country was occupied by the victorious Allied forces. Torn apart by the emerging Cold War conflict, two states emerged from the ruins of the Third Reich: the German Democratic Republic (GDR) in the East, a communist regime with strong ties to the Soviet Union, and the Federal Republic of Germany (FRG) in the West with a liberal democratic constitution. Although both states quickly recovered from the devastation left by the Second World War, Western Germany stood out in the following decades as a Wirtschaftswunder, or "economic miracle," quickly becoming one of the strongest economies in Europe. This period of economic growth would continue all the way into the early 1970s. At the core of the new development strategy for West Germany was the swift introduction of the Social Market Economy, combined with substantial financial transfers under the Marshal Plan and a currency reform enacted in 1948. Fueled by a heightened world-wide demand for industrial goods brought on by the Korean War, the period of the German economic miracle was characterized by skyrocketing increases in industrial productivity, along with historically low unemployment rates. Between 1950 and 1960 industrial production in West Germany had risen to two-and-a-half times the level of 1950, GDP grew by two-thirds, and the unemployment rate fell from 10.3 percent to an astonishing 1.2 percent (Haselbach 158).

Beyond its immediate success, the Social Market Economic System gained both popularity and recognition from the population at large in Germany. The degree of importance this system holds in the minds of the German people is best understood in light of the circumstances under which this system emerged. At the end of Nazi rule in Germany, recognizing the scale and gravity of the atrocities committed under it, the German people could not deny that as a group they had made a terrible mistake. In effect, this largely destroyed any sense of national pride upon which Germans could base their national identity. All chances had been lost to formulate a positive identification with "Germanness" and Germany's recent history.

However, a society cannot function for very long without a positive sense of collective identity, and in the wake of the post-war destruction and hardship, it was the return of prosperity under the economic miracle which would fill this void in the mindset of the German people. The renewed economic vitality which emerged under the institution of the German Social Market Economy allowed Germans to take pride in their collective industry and economic strength. The success of the German economy under the Social Market System came to form the founding myth upon which Germans based their collective national identity.

In its popular conception, the German Social Market Economy meant a departure from both the regulated Nazi economy and the planned Soviet economy. This system sought to balance a basic capitalist free-trade orientation with a set of state-managed social safety nets. It is important to note that this popular conception was not identical with the meaning that Social Market Economy had for the group of economists who had invented the term. However, as distorted as the public understanding of the term might have been, the ideological success of the German Social Market Economy among the German people was just as important to the success of the newly-formed FRG as the actual implementation of the system.

In the years immediately following the Second World War, the economic outlook for the majority of Germans was exceptionally bleak. The successful restoration of bearable living conditions for the German people, even in the most optimistic of expectations, appeared to be many years away. Everyday life was characterized by misery, destruction, and hunger. The task of clearing the rubble from German cities alone was expected to take a generation's work. According to the idealized version of the narrative that would become the founding myth of modern Germany, it was during this most desperate hour that the political initiative and vision of Ludwig Erhard returned the war-torn society to a path of economic success. Through the currency reform of 1948 and his liberal program for a new economic policy, Erhard catalyzed a period of unprecedented growth and prosperity which would last into the 1970s. The Social Market Economic System as instituted by Erhard had saved the people of West Germany from hunger and despair and made them successful and thus respectable once again. In light of these extraordinary achievements, it becomes understandable why a German author recently declared the Social Market Economy to be "up to now, the most successful conception of economic policy in the history of mankind" (Haselbach 157).[1] As extreme as this statement may sound, it is representative of a widely held belief within Germany.[2]

Considering the importance Germans placed on their economic system, it is easy to understand the great level of concern caused when that system began to falter. In 1966, Erhard himself had to resign his position as chancellor over a mild economic crisis. However, this event would pale in significance when compared with what was to come. The first major blow to the German economy came in 1975, following a dramatic upsurge in oil prices in the previous year. In 1975, West Germany's GDP fell to negative 1.4 percent growth (Ulman and Knut 22). Although GDP growth had recovered by the following year, it began a downward trend which led to another recession in the early 1980's. Throughout the following years leading up to reunification, West Germany continued to experience low growth rates, averaging only 1.9% GDP growth for the decade. Simultaneously in this period, unemployment in West Germany doubled, growing from 3.4% at the start of the decade to 6.8% by 1989.

During the time leading up to reunification in the German Democratic Republic, there was a growing sense of disenchantment with the communist eastern German government, and its planned economy. East Germans had suffered for years under a period of relative economic decline in the face of growing wealth and prosperity in the West. The Easterners were convinced that they had been kept from living up to their economic potential by the system which had been imposed on them following the Second World War. The foundational myth of the FRG was believed here as it was in West Germany. Many felt that once the constraints of the Soviet-style system of central planning were lifted, they too would experience the vigorous growth achieved by the West following the war. In short, many in the East predicted a second "economic miracle" to occur following reunification and the implementation of free markets under a liberal democratic government.

These views were widely held and propagated in the West as well. Following the fall of the Berlin wall, Chancellor Helmut Kohl helped win the election for his party's eastern subsidiaries by promising a currency reform in the summer of 1990, calling back the memory of the 1948 currency reform and its subsequent success. For the public, "currency reform" with the introduction of the economic and social laws of the West, i.e., the "social market economy," seemed to guarantee a repeat of the first miracle in the West. Chancellor Kohl proclaimed that the East would be transformed into a *blühende Landschaft* (blooming countryside) within a few years of

[1] This quotation, translated by Dieter Haselbach, was taken from Helmuth Seliger, "Alexander Rütow–ein Verteidiger des Mittlestandes," in *Perspektive 2000*, ed. Lothar Bossle (Würzburg: Creator Verlag, 1987), p. 116: "Die bislang erfolgreichste wirtschaftspolitische Konzeption in der Geschichte der Menschheit (ist) [...] unstreitig die von Ludwig Erhard in die Wirklichkeit umgesetzte Soziale Markwirtschaft."

[2] To give one more example: In 1977, the prominent political writer Rüdiger Altmann stated that "Social Market Economy" was "die erfolgversprechendste Wirtschaftspolitik des Kontinents" (the most promising economic policy of the continent"). *Wirtschaftspolitik und Staatskunst. Wirkung Ludwig Erhards. Aus Anlaß seines achtzigsten Geburtstags* (Bonn: Ludwig Erhardt-Stiftung, 1977), p. 5.

social and monetary union with the West. At this time, Ludwig Erhard's book from 1957, *Wohlstand für alle* (Prosperity for All), appeared newly in print and was distributed freely in East German streets. It was a widely held belief among the German people, both eastern and western, looking back on the German *Wirtschaftswunder* of the 1950s, that history was about to repeat itself (Haselbach 177).

However, the problems of stagnant GDP growth and rising unemployment, which had surfaced in the FRG in the 1980s, were only intensified following German unification. Since reunification in 1990, Germany has seen annual average real growth of only 1.8% and unemployment rates have averaged 7.5% over the same period (OECD Statistics 2007). Before unification, West Germany had maintained a great degree of social stability by alleviating social friction through the redistribution of wealth. The resulting welfare state with its generous unemployment benefits, universal health care, comprehensive social security, and indexed pensions was in turn dependent on a certain level of economic growth to finance existing programs (Witt 368). The expansion of social programs and entitlements to East Germany added pressure to the already strained social budgets while straining relations between East and West Germans. West Germans had to pay more into the social budgets during a time when benefits were being rolled back. And in the new federal states, the application of West German social legislation contrasted unfavorably with the much more comprehensive welfare system that had previously existed in the GDR (Haselbach 175).

Many problems now face Germany as it seeks to lower its unemployment, attract foreign investment, and return growth rates to acceptably high levels. In this paper, some of these important problems that Germany is currently facing are explored. Section I will focus on the differences between the mythos of the German Social Market Economy and the actual preconditions and policy actions which spurred the Wirtschaftswunder of the 1950s. Using this information as a basis, I intend to shed some light on why the second "economic miracle" never occurred. Section II addresses one of Germany's most pressing problems today, facing its very expensive and highly inflexible labor market. It will be suggested that the current system of autonomous collective wage bargaining is hindering Germany's growth potential and thus explains Germany's trouble reforming this system. In Section III, German economic reform strategy enacted in 2005, known as the "Agenda 2010," will be described, including consideration of some of the specific goals set out in this agenda and the progress that has been made in Germany in response to these measures. The paper concludes with an outlook on the upcoming challenges facing Germany as it adapts to a post-industrially structured society in the modern era of global capitalism.

Section I: The myth versus the reality behind the German Economic Miracle

In the years directly following the Second World War, the main task facing western policy-makers was to ensure the basic living conditions of the population while building up a new state and economy. Socialist and communist politicians argued for a central distribution system, extensive state controls, and the nationalization of banks and industry. Leading their opposition, in favor of a liberal or capitalist system, were two economist-politicians considered the fathers of the Social Market Economy: Ludwig Erhard, who had been appointed Minister of Economics in the first cabinet of Konrad Adenauer and who would later serve as German Chancellor, and Andreas Müller-Armack, permanent secretary in the Ministry of Trade and Commerce. These two figures held between them the most powerful positions in determining Germany's economic policy (Rösch 1-2).

The task of restoring West Germany to a path of economic success at this time must have seemed very daunting, both to the German people and to politicians like Erhard and Adenauer. Following the Second World War, daily life for Germans was characterized by the death and destruction left behind by the war, shortages of food and decent housing, and a growing national shame as the scope and scale of Nazi atrocities came more fully to light. And yet, very soon after these darkest of days, the West German economy was booming, unemployment was virtually nonexistent, and the German people could once again take pride in their collective industry and economic success as growth and productivity rates soared. The 1950s mark the decade of the German Economic Miracle, a miracle which many felt had come about thanks to the return of free markets under the Social Market Economy.

As successful as the Social Market Economy may have been in the time directly following its inception, its disappointing performance in recent years has called into question how much of the early success was due to the system itself, and how much had been caused by other factors. From the early 1970s until very recently, economic growth in Germany remained stagnant and unemployment rates hovered persistently between six and nine percent (See Appendix 1). Furthermore, during German reunification in the early 1990s, a time when German politicians and people alike predicted a second economic miracle following the introduction of western liberal markets in the East, the economic woes of West Germany were only compounded as it struggled to modernize the severely outdated Eastern industrial base. Eastern Germans, rather than experiencing unprecedented growth and prosperity, as had occurred years earlier in the West, suffered under growing unemployment rates that skyrocketed to as high as twenty percent in many areas (Ulman 14).

Questions concerning these developments in

Germany over the last decades abound: What were the factors that catalyzed the Economic Miracle of the 1950s in West Germany? Why could this success not be duplicated years later in the East? And most importantly, how might united Germany change its system to restore growth and unemployment rates to acceptable levels?

To answer such questions, one must first consider the factors stimulating the success of the 1948 currency reform. After the collapse of Germany in 1945, the German economy rapidly deteriorated into a barter economy. During this period, German money was rendered virtually useless, serving neither as a means of payment nor as a store of value. Individuals and firms were forced to acquire most of the commodities they needed by exchange against commodities they had to offer. Often it was more profitable for employees to skip work for part of the week so that they could cultivate private gardens, or barter for commodities on the black market. By the middle of 1948 the economy had reached a state of paralysis resulting in near-starvation for a large part of the population (Lutz 122). It was against this backdrop that the currency reform of 1948 was enacted.

One of the key reasons why the miracle of economic recovery in Germany became so convincing was the claim that West Germany was starting from scratch at the time of the currency reform. On the 20th of June in 1948, the day of the currency reform, each West German citizen received forty *Deutsche Marks*, the new money to replace the inflation-stricken *Reichsmark* (Haselbach 161). Referring to the Social Market mythos, this was the first day in Germany when free markets were able to work their magic. In the course of this day, the black market suddenly disappeared in correspondence with the return of the supply of food and commodities. Shop windows that had been empty the day prior were now adorned with a new abundance of much-needed merchandise. Following years of want and starvation, this day did seem like a miracle to the millions of Germans who lived through it.

Although the astounding change accomplished on the day of the currency reform did much to restore the confidence and optimism of the German people, calling it a miracle ignores many of the key elements that contributed to its fruition. The currency reform did not kick off recovery. Rather, it was one carefully staged step in the process of returning Germany to the path of economic growth (Haselbach 162).

One of the most significant factors contributing to Germany's successful economic recovery following the war was the presence of a modern and relatively intact industrial base. Under National Socialism, particularly during the war, Germany's economy had been very successful for two main reasons. For one, through their military acquisitions during the war, the Nazis had access to an abundant supply of labor in the occupied territories and were able to exploit a wealth of raw materials to which they had gained access. Also, the system of economic planning under the Nazis had been quite successful. The Nazis succeeded in combining the resources at their disposal with the initiative of the German economy that they had inherited. Although the destruction resulting from Allied bombardments in the final weeks of the war had been devastating to both the housing and the transportation infrastructures, much of the industry proper was left relatively untouched. All in all, due to Nazi successes, Germany's postwar economy inherited a highly modern industrial stock.[3] To a great extent, it was this inherited industrial base that set the stage for the subsequent successes experienced under the Social Market System (Haselbach 163).

The immediate and visible success of the currency reform in 1948 can be attributed to other factors preceding that landmark day. As early as 1947, the economy had already turned a corner toward recovery thanks to a carefully crafted policy of central allocation of scarce resources. The introduction of the new currency would not have been effective without the preexisting recovering economy to back it (Ibid 164).

The sudden appearance of commodities in shop windows on the day of the reform can be understood in light of the manner in which the reform was introduced. German politicians had openly announced the coming of a major day of economic reckoning months before the reform itself. This information had sent wholesalers and producers a clear signal to hoard commodities. Knowing that the reform was imminent, traders did not want to sell against the dying *Reichsmark*, waiting instead to exchange their goods for the newly established *Deutschmark* (DM). In the month preceding the reform, the supply of goods in retail shops had dried up almost completely, only to be newly replenished with the introduction of the new currency (Lutz 132).

Along with initiating the return of commodities to German shops, the currency reform marked the beginning of substantial increases in productivity and output in the German economy. Before the close of the year in 1948, industrial production had already risen by an astounding 53 percent (Ibid 133). This rapid growth was set off by a number of significant factors. Prior to the currency reform, part of production undoubtedly went into hidden stocks, or was used for bartering purposes, and was not reported. Thus output figures preceding the reform most likely underrepresented actual output. Also, the introduction of the new currency significantly lowered the rate of absenteeism in the work place. Following the currency reform, the rate of absenteeism dropped from 9.5 hours a week in May to only 4.2 hours by October. The new currency

[3] In contrast to the West, where occupying Allied forces left much of the German industrial as it stood at the end of the war, following the war, much of eastern Germany's industrial stock was disassembled and carried off by the Russians.

had made it once again worthwhile to work for money, rather than spend time foraging and bartering. Moreover, with the return of a functioning currency came a drop in the real costs associated with executing business transactions. Time formerly spent arranging complicated barter agreements could finally be used toward more productive ends (Ibid 133).

The visible effects of the reform evident in shop windows, combined with substantial increases in output productivity and quality of life, helped to convince the public at large that the new currency was reliable. This, in turn, boosted consumer confidence, further aiding the progress of economic recovery. Economic growth in Germany was additionally aided by an increased world demand for manufactured goods, stimulated by the Korean War. For much of this period, German exports also enjoyed a competitive advantage in international markets because the German currency was undervalued, making German goods cheaper in foreign markets (Haselbach 163-166).

Given this extraordinary set of circumstances, Germany was well positioned for a boom as it entered the 1950s. This growth potential certainly could have been spoiled by ineffective economic policies, and much credit is due to both Erhard and the West German government at that time. However, crediting the theoretical formula of the Social Market Economy for the success enjoyed during this decade is wrong for two reasons: because it ignores the governing set of circumstances preceding the expansion, and because the policy actions of Ludwig Erhard were less driven by a coherent theory of economic practice than by an astonishing pragmatism (Ibid 164). Although the Social Market Economy might well be described as a variation of market liberalism, and under Erhard markets were indeed liberalized wherever economically feasible, he did not hesitate to resort to state control and planning in fields where it seemed appropriate to him, such as in housing, coal supply, or agriculture. Social market theory recommends the establishment of markets framed by institutional regulations, with these regulations standing as the only checks against the self-destructive tendencies in market economies. However, Erhard did not follow this form of governance, instead using state action in the market proper as a standard tool of his policy (Ibid 164).

These conditions surrounding the introduction of the Social Market Economy are important to remember when considering the disappointing outcome following the introduction of the West German currency in the East after reunification in the 1990s. Most notably, the currency reform of 1948 did not, in and of itself, catalyze recovery. Rather, it was merely a step amongst a large set of preexisting circumstances which, as an aggregate, produced the vigorous growth rates of the 1950s.

How different was the situation in eastern Germany in the time leading up to reunification! Virtually none of the factors contributing to West Germany's success in the 1950s were present in East Germany leading up to the 1990s. East Germany had suffered from a long period of relative economic decline in the face of the growing wealth in the West, which left it with an outdated industrial stock, as opposed to the modernized stock of West Germany following World War II. Rather than possessing an undervalued currency to boost competitiveness in international markets, East Germany was burdened, under the "currency reform," with the highly appreciated DM, making East German goods more expensive in foreign markets. The introduction of this new currency not only failed to help the eastern German economy, but it hurt the area and contributed to a sharp decline of economic activity. It was only the comparative strength of the West German economy and an enormous and ongoing transfer of wealth that kept East Germany's economy from a total breakdown, since it was fully exposed to the world market after currency reform (Haselbach 178).

The disappointing performance of East Germany following market liberalization and the introduction of a western currency illustrates the point that growth and economic success are not guaranteed by trade liberalization if other necessary preconditions are not also met. In the same way, it was not so much the Social Market Economy that was responsible for West Germany's success, but rather a combination of the aforementioned preconditions in combination with an appropriate economic policy.

Section II: The high cost of labor in Germany

When asked what could be causing the chronically high rates of unemployment experienced in Germany over the last several decades, political and economic experts alike point to a high-cost and highly inflexible labor market.[4] Simply put, it has become too expensive for many firms to hire workers in Germany. Furthermore, once a firm has hired workers in the country, an extensive body of labor laws and restrictions regulates nearly every aspect associated with maintaining those workers, including making it very difficult for firms to lay them off (Economist, 2003). Over the years, these factors have forced firms in Germany to either reduce employment or move elsewhere, and have scared away a multitude of outside investment and employment opportunities.

The vast array of labor market problems in existence today may be attributed to the nature and development of industrial relations in Germany. The Social Market Economic system, which emerged from the post-war period under the guidance of Ludwig Erhard, is often described as a blending of ideas from liberal thought (most notably, stressing a basic free-trade orientation) with a set of social precepts that modify

[4] The debate over Germany's attractiveness as a location for investment in production facilities is encapsulated by the phrase "Standort Deutschland" and can be found in a wide array of academic publications. For a good description of the issue see Harding (1999), Tüselmann (1995, 1998), and Zumwinkle (1995).

the outcome of the market process through redistributive measures for the sake of balance and social security. These social precepts indicative of the Social Market Economy were incorporated via a system of extensive social welfare, along with a system of autonomous collective wage bargaining (Witt 366).

This system of collective bargaining, which comprises the defining element of German industrial relations, won support in the aftermath of the Nazi era as a counterweight to the power of the state and large-scale industry in the operation of the Social Market Economy. While it was the responsibility of the government under this system to socialize risks and provide economic security to wage earners (i.e., to provide social welfare), this power was counterbalanced by the constitutionally guaranteed autonomy of trade unions and employer associations in the determination of wages under collective bargaining. The latter institution was intended to function as an instrument of social justice by establishing parity of bargaining power between workers and employers. It was also the intent of this system to help reduce income differentials and tensions between the two classes and avert industrial unrest (Koch 234-254). Although the system of collective wage bargaining has proved successful in many of these respects, this institution has also had a number of unfortunate consequences.

As a direct result of Germany's system of industrial relations, the cost of labor in Germany, represented by wages or salaries and non-wage benefits, has risen over the past thirty years to one of the highest levels in the world. West German workers cost on average €27.60 an hour, compared with €19.90 in Britain and €18.80 in America (Economist, Aug 2005). A large portion of these labor costs can be attributed to so-called "non-wage labor costs." According to the annual analysis by the Institut der Deutschen Wirtschaft, non-wage labor costs are defined as those categories of the enterprise's total labor costs other than direct compensation (Chen 2). From 1972 to 2000, the ratio of non-wage labor costs to direct compensation grew by 25.6 percentage points to 81.2%. This represents the highest level of non-wage labor costs in the Euro-zone (Institut der Deutschen Wirtschaft 2001, table 148).

Apart from expensive labor, corporations in Germany must shoulder a heavy tax burden and a set of highly inflexible market regulations. As of 2004, the basic level of corporate tax stood at 38.7%, the highest rate in Western Europe (Economist May 8 2004). Furthermore, labor regulations developed under the German system of industrial relations have made it extremely difficult for firms to fire workers once they are employed. For example, at the end of 2003, it took Software AG, a globally active firm based in Darmstadt, three months to lay off 200 of its employees. In the U.S., the same measure took the company only two weeks to complete. The fact that it was possible for Software AG to make these lay-offs at all was only due to the enactment of Agenda 2010 reforms earlier that year, which loosened job protections enough to allow the lay-offs to occur (Economist May 8 2004). In the modern era of increasingly free trade and global capitalism, firms are gaining considerably more freedom to locate their production facilities in areas where factor costs are most efficient. The combination of high costs and inflexibility has both discouraged outside firms from investing in Germany and caused many of Germany's domestic firms to move their operations elsewhere, for instance to central European countries where labor costs average below €5 per hour (Economist, Aug. 20 2005).

At first glance, Germany's system of autonomous collective bargaining between employers' associations and trade unions may seem to be both an effective and efficient method for protecting worker interests. Indeed, the system has enjoyed great popularity and acclaim over the years of its existence, both within Germany and in other European countries where it has often been cited as an exemplarily stable and highly functional model for the regulation of working conditions. The principle of co-determination between management and employees, carried out on the company level in Germany through the works council (*Betriebsrat*), most notably in the 1960s, helped create a strong foundation within German companies by maintaining harmony between workers and employers (Economist May 8 2004). Further, because the whole process is self-regulated by the union and employer groups directly involved, it relieves the state of the burden of regulating and legitimating labor standards (Winter 183).

As numerous as arguments in favor of Germany's model of industrial relations may be, there remain manifold aspects of the system that are clearly problematic in both a theoretical and an empirical sense. Throughout the course of years of repeated wage negotiations, union representatives have succeeded in obtaining an income distribution significantly higher than the competitive outcome, and have shielded union workers through extensive labor laws to a great extent against layoffs and other job risks. Unit labor costs in Germany, which stood at 60 percent of the U.S. level in 1970, reached over 140 percent by 1990. In this same period, productivity growth in Germany was lower than in the U.S. (Ulman 12). While these accomplishments are certainly very beneficial to union members, their effects have proven devastating to firms that must compete on the global market. Furthermore, this method of socially correcting free markets gives rise to a rent-seeking dilemma that casts doubt on whether the implementation of such a method has anything to do with the pursuit of social goals at all.

In his paper titled "Germany's Social Market Economy: Between Social Ethos and Rent Seeking," Ulrich Witt of the Max Planck Institute for Research into Economic Systems outlines with great clarity the dilemma associated with Germany's system of collective, centralized wage bargaining. He begins with the concession that decisions in negotiations

are indeed reached by mutual agreement between the labor and employer interests. He continues by qualifying that this agreement is made by the representatives of the associations and not by the individual parties bound by the wage contract. Witt argues that in this seemingly insignificant detail lies the system's greatest problem:

> The majority opinion within the employer associations determines their judgment about the acceptability of an agreement. Experience suggests that this opinion is based on whether the resulting cost increases (direct wages and salaries plus non-wage labor costs) of different grades of labor can be recouped without loss of profitability in the industry. It is doubtful, however, whether the majority opinion, especially under the pressure of actual or potential strike, takes sufficient account of the variance in the profitability of all member firms. Because the member firms are not allowed to pay less than the union rate, firms at the lower end of the profitability distribution are forced to reduce employment or even to go out of business when wages and non-wage labor costs rise. This outcome occurs even where the employees of these firms are willing to work under conditions worse than those specified in the agreement. (Witt 372)

In other words, by requiring wage and benefit increases to be implemented across entire industries, many companies that under normal circumstances would be economically viable are no longer able to make profits, resulting in the need to lay off workers, move facilities elsewhere, or even terminate operations. Until very recently, despite the fact that the unemployment problem has been growing progressively worse since the mid-1970s, German labor unions have continued their strategy in negotiation rounds of seeking wage and benefit increases equal to the estimated average annual gain in labor productivity. Union representatives in practice do not have to admit responsibility for ill effects resulting from their contracts because, in the Social Market Economy, the individual unemployment risk is covered by state-managed social insurance and public assistance. To frame the problem in the economic terminology of costs and benefits, the benefits of an expansive wage policy are reaped privately by union members, while the costs are born collectively by German taxpayers (Witt 372-373).

Although the problems resulting from the highly expensive and inflexible German labor market have become increasingly obvious, efforts towards reforming the system of collective wage bargaining behind it have been held back for a number of reasons. First and foremost stands the country's federal power structure, spread over the 16 independent *Länder*, which was deliberately designed after the Second World War to weaken the ability of a central government to impose radical reform. Numerous failed attempts to reform Germany's labor laws in recent years have proven this system to be all too effective (Economist May 8 2004). Furthermore, the Law on Collective Agreements (*Tarifvertragsgesetz*), which forms the legal basis for sectoral relations between employers and unions, was incorporated into the German Constitution (*Grundgesetz*) in 1949 and has remained largely unchanged ever since (Winter 189). Finally, the system of collective bargaining has operated in Germany for many years, retaining a high degree of popularity in the country. As a result, politicians frequently shy away from the issue of reforming Germany's cumbersome and expensive labor laws (Economist May 8 2004).

Although the system of collective wage bargaining in Germany certainly has resulted in healthy worker/employer relations and a high degree of wage equality across employment sectors throughout Germany, the problems resulting from the system, such as high unemployment and an inflexible labor market, bring into question whether the system has helped Germany at all. In spite of the many arguments claiming that free competition will ultimately drive wages below the cost of living,[5] one thing is clear: if the problem of unemployment in Germany is ever going to be solved, the country must move to deregulate its labor markets and lower the cost of employment to a more competitive level. Although such reforms might sacrifice a certain degree of pay equality, the benefits brought on by lower unemployment and higher economic growth would certainly result in an increased level of "*Wohlstand für alle*" (prosperity for all).

Section III: Agenda 2010

In 2005, former German Chancellor Gerhard Schröder spearheaded a series of reforms known as Agenda 2010. The purpose of this reform package was to modernize the German social system and labor market. The main aims of these reforms were to improve economic growth and thus reduce unemployment. The agenda focused on three areas: the economy, the system of social benefits, and Germany's position in the world market. Specific reform steps to be taken included reductions in health care benefits, restructuring labor regulations, tax cuts, and an overhaul of the pension system (*Deutsche Welle* Oct. 17 2003).

In a speech delivered on March 14, 2003 introducing the reforms, Schröder asserted that a massive effort from all sections of society would be needed to carry out these important reforms. Indeed, the span and magnitude of the Agenda 2010 reforms were unprecedented and touched on a wide range of government actions. Monthly premium

[5] A popular form of this argument denotes competition via free markets and global capitalism as a "race to the bottom." Another argument, encapsulated by the phrase "low wage or no wage," focuses on the trade-off between greater pay equality and higher unemployment versus lower unemployment and greater pay inequality. For a good summary of this debate, see Brueckner, 2000.

payments for the national healthcare system were to be gradually reduced from 14.3% of an employee's income to 12.15% by 2006. The reduced premium was aimed at lowering Germany's staggering non-wage labor costs. To finance the cuts, certain non-vital health procedures would no longer be financed by the public health fund, and patients would be required to co-pay for doctor visits and prescriptions Also, to introduce more flexibility into Germany's heavily regulated labor market, a reform was passed making it easier for companies to hire and fire employees (Eironline Mar. 31 2003).

The most controversial section of the reforms, known as Hartz IV, merged unemployment and welfare benefits. The Hartz IV reforms reduced to 12 months the time during which a person can receive maximum unemployment benefits following job-loss. In addition, long-term unemployment benefits, which formerly paid out as much as 57 percent of a person's last regular net income, were reduced to a capped level of 345 Euros per month. These benefits were further qualified, making those with a working spouse or assets exceeding 13,000 Euros ineligible for payments. Also included in this reform package was a tax cut changing the country's progressive tax rate from 19.9% to 15% at the lowest level and from 48.5% to 42% at the highest level. Other reforms included eliminating the requirement of a master craftsman's diplomas in 65 skilled trades before a worker is allowed to be self-employed, an increase in the age of pension eligibility from 65 to 67, along with a reduction of pension levels from 40.1% to 38% of a recipient's former income, and an increase in the percentage received by communities of local business tax from 2.2% to 3.6% (*Deutsche Welle* Oct. 17 2003).

The Agenda 2010 reforms have already helped the economy make a remarkable turnaround. In 2006, Germany's GDP was up by 2.7%, the highest increase since 2000. Productivity also rose by 2%, a remarkable improvement, considering productivity growth averaged only 0.7% between 1998 and 2004 (Investor Business Daily Apr. 9 2007). Germany's traditionally strong export sector has also been booming, with exports increasing by 12.5% in 2006. A recent survey from Ifo., a Munich economics-research institute, shows business confidence to have reached a 15-year high. This recent succession of improvements serves as an indication that Germany is well into the upward curve of a typical eight-to-nine year investment cycle (Economist Jan. 5 2007).

Two years ago such a turnaround seemed hardly possible. In March of 2005, unemployment peaked at 12.1%. This alarming rate of unemployment helped convince German unions to agree to longer hours and even wage cuts in some cases. Such concessions in combination with recent reforms have allowed German corporations to make considerable improvements in cost competitiveness. Since the end of 2001, unit labor costs have fallen by 13.4%, compared to a 7.7% increase in the U.S. (Investor Business Daily Apr. 9 2007). Real wages per employee since 2000 have increased a modest 6%. This recent practice of wage moderation has given German companies a comparative advantage over rivals in France, Italy and Spain where, in the same period, wages increased by 12%, 18% , and 27% respectively (Economist Jan. 5 2007).

To a great extent, this recovery has been driven by the recent successes of Germany's large corporations. Over the past two years, they have been making significant structural adjustments, cutting costs vigorously, investing abroad and holding down wages. Recent government reforms have also helped companies regain their competitive edge, by introducing more labor flexibility and lowering corporate taxes from 38.6% to 29.8% (Investor Business Daily Apr. 9 2007). As a result, corporate profits in Germany are healthy and the DAX, a stock index for Germany's top 30 companies, climbed nearly 30% in 2006 to its highest levels since 2000 (Ibid).

Although the economic situation in Germany has improved considerably over the last year, the outlook for the next several years is not entirely rosy. Doubts remain about the durability of this recent German revival. The German Achilles' heel of low consumer spending has failed to make significant improvements in recent years. Although domestic consumption has picked up, improvements have been largely confined to the areas of transport, communications, leisure and entertainment, with consumers still holding back when it comes to spending on food, holidays at home, and clothing (Economist Jan. 5 2007). Third quarter data from 2006 shows expenditures as being up by only 0.8% since 2003, when expenditures decreased by 0.5% (Warton Mar. 28 2007). This would indicate that recent GDP improvements have been largely sustained by German exports, leaving Germany susceptible to a downturn in the global economy. Furthermore, the strengthening euro in relation to the weakening dollar will undoubtedly put increased pressure on Germany's export sector in the coming years (Ibid).

Outlook: The Need for Further Reform

In a speech given to a conference by the Federation of German Industries (BDI) and the Confederation of German Employers' Associations (BDA) on October 16, 2006, Joaquin Almunia, the European Commissioner for Economic and Monetary Policy, evaluated the progress of the Agenda 2010 reforms and proposed a number of further steps the German government should take in reforming its economy. In his speech he praised German efforts at reducing administrative burdens and the costs of starting a new business. He stated that the overall strength of the recent reform efforts was the determination to raise the country's innovative capacity. Citing the Commission's assessment of the 2005 reforms, Alumnia highlighted the need for more competition in Germany, particularly in public procurement, in professional services, and in the provision of broadband services.

Germany faces the additional long-term challenge of boosting its growth potential against the backdrop of unfavorable demographics—an aging population and a low fertility rate. One way to do this is to encourage business investment. Strong investment growth will lead to a faster expansion in the capital stock and a correspondingly strong rise in production capacities. In order to encourage future investment, Germany must continue its efforts in moderating labor costs and reducing the burden of restrictive labor laws. Although, lower growth in labor costs is unlikely to improve domestic demand, over the long-term wage moderation will help to strengthen and sustain Germany's competitiveness on the global market. If Germany continues to make progress, investment will continue to rise and consumer demand will benefit from greater growth in disposable incomes (Wharton Mar. 28 2007).

The ambitious measures set forth in the Agenda 2010 reform package have already done and will continue to do a great deal to prepare Germany for the age of global trade and competition. The lofty aims of delivering sustainable growth, full employment, stability, and security within Germany and the European Union, are desirable and deserving of the universal efforts of EU member states toward their achievement. Furthermore, in order to preserve Europe's uniquely high standard of living over the coming years, it is absolutely necessary that these issues be addressed and dealt with effectively. If carried through, these policy actions will continue to both shape the face of Europe positively and to serve as a model for nations adapting to a post-industrial economic structure for years to come.

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Mentor Comments

As Dr. Judith Ricker writes to recommend publication of Mr. Cheek's research in *Inquiry*, her enthusiasm is obvious.

> *Robert Cheek, a Chancellor's Scholar majoring in German, Economics and European Studies, has completed an exciting, original, and highly relevant research project. In keeping with his broad range of interests, he selected a multi-disciplinary project spanning half a century and involving all three fields titled "What Is Ailing the German Economy? A Critical Analysis of German Social Market Economics." This project allowed him to draw on information gained in relevant courses taken on this campus as well as in Austria, where he spent his junior year studying at the Karl-Franzens-Universität in Graz.*
>
> *Ever since I have known him, Robert has been keenly interested in the economic situation in Germany. When time came for him to select a research project, he wanted to explore why the German economy had been stagnating for years. It was at a time when Chancellor Schroeder, a socialist, had tried to introduce badly needed changes but had continued to lose voter support. In a desperate attempt to solidify his position,*

he called for early federal elections. Robert followed the heated debates about the future of the German economy that ensued and dominated the campaign against challenger Angela Merkel. All major and minor parties offered economic remedies. When neither major party won a solid majority, the country was thrown into turmoil. Ultimately, Schroeder stepped down. The coalition that was formed required compromises that made it difficult for Germany to push through the major changes necessary for the German economy to begin flourishing again. Robert had the unique opportunity to monitor policy changes as they evolved when the Merkel government took over the reigns.

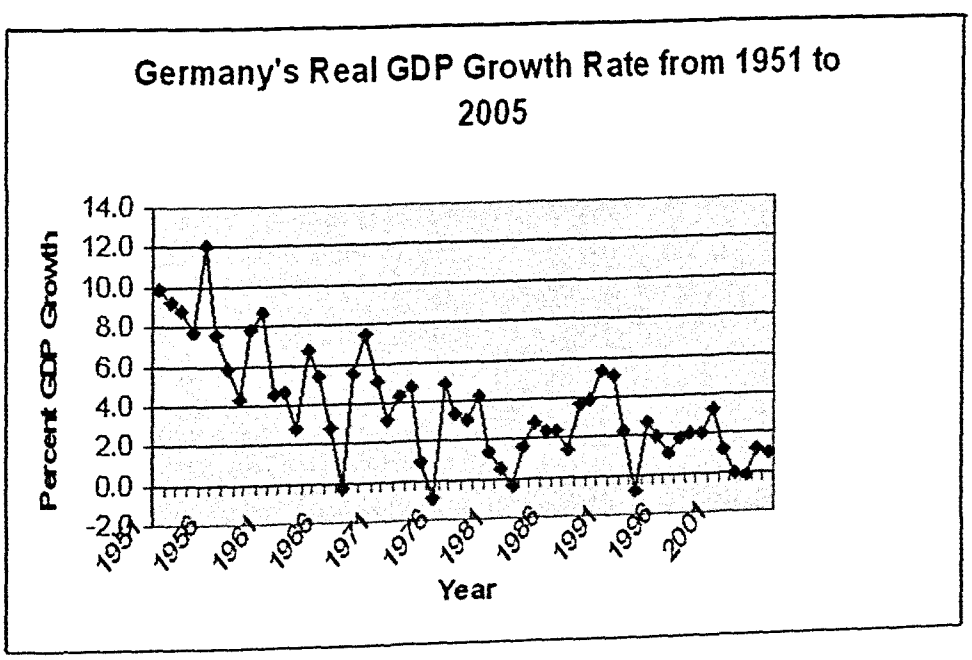
As Robert researched his topic, he became more and more interested in the history of the German economy. Specifically, he wanted to explore why the Wirtschaftswunder, the "economic miracle" that had defined the post-war German economy, could not be duplicated in former East Germany after the unification.

In order to provide an answer to this question, Robert had to go back to 1945 to identify the factors that lead to the Wirtschaftswunder and explore the economic schools of thought that subsequently lead to the highly successful Social Market Economy of the Federal Republic. It is to his credit that he looked beyond the myths surrounding the post-war German economic boom, studying instead the main theoretical bases for the Social Market Economy.

The next step was for Robert to assess the conditions that existed in the former German Democratic Republic, comparing them to the conditions in post-1945 West Germany, as well as the economic conditions in the old Federal Republic as the two Germanys were reunited. He identified the principle problems that prevented a second economic miracle from occurring and, along the way, identified what ails the German economy. He ended his study with an analysis of recent German strategies, principally Schroeder's Agenda 2010 reform package, to address the challenges that mature, post-industrial economies like Germany's face due to increased globalization.

Robert's project was very challenging. He read through a vast amount of sophisticated literature, both in English and in German that provided him with the background information he needed. The fact that had the language skills to read widely in both languages was critical for the project.

Appendix 1



Source: International Monetary Fund. "World Economic Outlook: Spillovers and Cycles in the Global Economy." *World Economic and Financial Surveys* April 2007.