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The employment crisis of the German welfare state
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How did the German welfare state fare in the 1990s and what are its prospects for the near future? If one were to follow recent accounts of two influential German social scientists there does not seem to be reason for much concern. By looking at a wide range of comparative data, Jens Alber¹ finds that the German welfare state in almost all dimensions is located at or very close to the OECD or EU median. Welfare entitlements are not overly generous in Germany, nor is the welfare state especially expensive when compared with its European counterparts. Nor are social programmes particularly inefficient. According to Alber, it is rather its ‘lack of distinctiveness’ which makes the German welfare state distinctive. Given that the German welfare state appears to be almost a ‘median on all dimensions’, Alber finds no empirical support for the rhetoric of crisis that is so pervasive in the current debates about ‘Standort Deutschland’.² In a similar vein, Manfred Schmidt³ holds that Germany is still following the ‘politics of the middle way’ because a multi-veto point polity prevents extreme swings of both the economic or political pendulum from occurring. While the overall performance of German capitalism may have suffered after unification, Schmidt’s general message is that Germany still performs astoundingly well in economic terms and that its institutional order still reveals a remarkable stability. In fact, since unification has not led to a profound alteration of the way in which the German model functions, for many, unification is both the cause of a temporal crisis and the proof of the basic health of the German model. The economic costs of this dramatic ‘shock to the system’, so the argument goes, only overshadow the still impressive international performance of the German economy and the notable robustness of its political order. Hence, a fundamental critique of the German model is largely unjustified and would – if followed up – cause more harm than good.⁴

The following analysis argues that the current widespread feeling of crisis in Germany is indeed much better founded than these accounts
concede – at least if one focuses on the welfare state and the closely related performance of the German labour market. We claim that the economic slumps since the early 1970s – including the unification crisis after 1992 – have regularly triggered a pathological response pattern of the German economic and political system leading to ever higher levels of unemployment, to a low level of total employment, and to steadily increasing non-wage labour costs, in particular continuously rising social insurance contributions. In turn, high non-wage labour costs have adverse effects on job growth in the low wage (service) sector and on the competitiveness of German industry in world markets.

What do we mean when we speak of a ‘pathological response pattern’ in the German economic and political system? The pathology of economic adjustment to recessions takes roughly the following course. Both the independence of the German central bank and the federalist fragmentation of the ‘public purse’ prevent the use of strategic depreciation or expansionary fiscal or monetary policies to maintain high levels of employment in times of economic crisis. Real wage flexibility is also not sufficient to prevent large-scale job losses. Consequently, it is the welfare state that becomes the main instrument of economic adjustment. Germany’s prime response to economic crises is the reduction of labour supply with the help of various social insurance schemes. Given the real-wage resistance in the German wage bargaining system, an increase in labour taxation translates into higher wage costs. While this burden already puts both the system of social protection and the labour market under stress, the response pattern of the German political economy to economic crises has yet another pathological side to it. Given that the Bundesbank’s tight monetary policy forces the government to pursue strict fiscal discipline – a pressure that is especially felt in times of economic slump – the financial autonomy of the social insurance schemes’ budgets provides the government with a strong incentive to shift financial obligations out of the general budget into these budgets or to reduce the state’s overall financial involvement in social spending. Thus, economic crises trigger a dual process of cost shifting: firms seek to externalise their adjustment costs onto the welfare state, and the government tries to ease budgetary pressures by reducing its contribution to welfare finance.

The steady increase in non-wage labour costs endangers the competitiveness of German industry in world markets and at the same time impedes the growth of the domestic service sector. Declining employment, in turn, is particularly problematic within a social policy model that relies almost exclusively on revenue stemming from dependent employment. The
resulting financial crisis of the welfare state and the labour market distortions caused by the exaggerated cost burdens imposed on wages were seriously aggravated by German unification, but have in fact been noticeable since the mid-1970s. The discussion proceeds as follows. Since the pathology of adjustment is the result of the strategic interaction of economic and state actors within the German economic and political system, we first give a brief account of the basic functioning of this broader political-economic framework, before describing the emergence of a pattern of pathological adjustment after the high growth/full employment period had come to an end. We then discuss in greater detail the policy responses in the 1980s and 1990s before considering the impact of unification on the welfare state and the German labour market. In the final section we briefly discuss the adverse effects of the resulting welfare-without-work equilibrium on structural change and the competitiveness of German firms.

A SKETCH OF THE GERMAN POLITICAL ECONOMY

Central to the German social market economy (Soziale Marktwirtschaft) is a high degree of autonomy of the German Bundesbank, strong unions and employers' associations, which jealously defend their constitutionally guaranteed right to free collective bargaining without any state intervention (Tarifautonomie). The welfare state comes close to Richard Titmuss' industrial achievement/performance model. It emphasises occupational status and transfer payments rather than the direct provision of services. Public employment is low. Apart from central bank independence, federalism is the second most severe source of restriction on government independence in fiscal, monetary and economic policies and grants the Länder (states) a say in almost all matters of federal legislation. Thus, negotiation is the dominant mode of decision making and conflict resolution. Policy co-ordination between the federal government and the Länder, if it happens at all, is the end-result of protracted processes of political compromising. Blockages and political stalemate occur frequently and sweeping reforms are rare due to the meshed jurisdictions between central and state governments and the strong legislative veto-position of the states in the upper house (creating a 'joint-decision trap'). The potential for political obstruction is aggravated by the competitive character of the German party system. Over time the political parties have learned well how to exploit the opportunities that the German multiple veto-point polity offers to them.
State intervention in the economy is not absent, but rare, since business associations have shown a very high capacity for efficient self-governance and the German collective bargaining system has functioned smoothly for most of the post-war era. The strike rate is low, while the coverage rate of collective agreements remained high and stable – despite medium and, since the 1980s, steadily decreasing union density. Wage bargaining takes place in a mainly voluntary framework, but the Bundesbank's credible threat instantly to punish inflationary wage agreements has had strong disciplinary effects. The high binding force of collective agreements is due, first, to the high organisational density of employers; second, to legal provisions that endow voluntary agreements between unions and employers with quasi-official, authoritative status; and, third, to the joint interest of employers to avoid wage competition and to protect the high-skill, high-wage production regime that crucially depends on the banning of sectoral wage competition.

The German system of industrial governance can be labelled corporatist. German corporatism, however, is different from the central corporatist concertation of the Austrian, Swedish or Dutch variety. German industrial relations are rather an example of horizontal or 'covert' co-ordination. To exaggerate only slightly, one might label the German industrial relations system not as 'corporatism without labour', but rather as 'corporatism without the state'. The German welfare state primarily covers risks associated with a loss of income of the male industrial wage earner, such as sickness, old-age and unemployment. Each risk is dealt with by a separate social insurance scheme. The relatively strict adherence to the insurance or equivalence principle means that entitlements follow very much the income distribution generated by the market. Hence, the welfare state puts a premium on steady working careers and therefore benefits workers with relatively high skills and thus high incomes, while it discriminates against part-time work and, as a consequence, also against female labour force participation. These welfare-induced rigidities support the so-called 'standard employment relationship' (Normalarbeitsverhältnis), that is, full-time, life-long employment.

The main beneficiary of this welfare state model has been the male, skilled, unionised worker in the manufacturing sector. With respect to financing, the overwhelming part of social spending is financed from social insurance contributions. The sickness fund budgets are entirely autonomous, so contribution rates have to increase whenever a deficit appears. The pension scheme receives a subsidy from the government. Nevertheless, the lion's share is financed by contributions of employees
and employers. The share financed from the government's budget declined from 31.9 per cent in 1957 to around 19 per cent in 1970 and has slowly risen since (today it is at approximately 24 per cent). Contribution rates rose from 14 per cent of gross wages to 19.5 per cent today. Whenever the revenue from contributions and the state subsidy (as a fixed share not linked to outlays but to revenue) were insufficient to meet the expected expenditures, the contribution rates had to be raised by law. Unemployment insurance is also subsidised. The system is run by the Federal Employment Office (Bundesanstalt für Arbeit) and, once again, is mainly contribution-financed. Deficits must, however, be covered by the federal budget. Means-tested social assistance as the ultimate safety net of the German welfare state is run and financed by local authorities under national legislation. This also represents an in-built incentive for the central government to shift costs out of programmes where it is financially involved in social assistance.

THE END OF THE ECONOMIC MIRACLE

With the end of the German economic miracle in the early 1970s, the reduction of labour supply became the dominant 'solution' to German labour market problems. Foreign workers, so indispensable during the boom of the 1960s, were the first to be affected. At about the same time, the use of the social insurance schemes as a means of reducing the supply of labour rose to prominence. The use of early retirement was of particular importance.

About a year before the onset of the first OPEC crisis, the pension reform of 1972 had opened up the possibility of 'flexible retirement' at the age of 63 without an actuarial reduction in benefits. The introduction of this measure was completely unrelated to considerations about using early retirement to ease labour market pressure in economic downturns. On the contrary, after very high wage increases and considerable economic growth in the years between 1969 and 1971, the budgets of the social insurance schemes showed a surplus, and the faith in the effectiveness of Keynesian deficit spending that still prevailed at that time led politicians to extrapolate the present growth rate and budget surplus for the entire decade. However, the substantial welfare state expansion brought about by the pension reform of 1972 took place against the background of the first oil crisis. It is clear that, with the deteriorating economic situation, flexible retirement became increasingly attractive among older workers. While the introduction of flexible retirement caused a decline in the take-up rates for disability pensions as the second pathway into early retirement, in the years following
the recession the number of entrants increased again. This was also due to two important court rulings (in 1969 and 1976) that held that the definition of ‘inability to work’ must also take the situation on the labour market into consideration, that is, the probability for a less than fully employable, but not fully disabled person to find adequate part-time employment in his or her respective profession. Since the German labour market regime offers only few part-time positions, older workers regularly qualify for a full disability pension even if they have only a partial ability to work. The third variant of early retirement is the so-called 59er rule. The practice makes use of a regulation that establishes the right for those aged 60 or older to claim a pension if they have been unemployed for more than one year. This provision was used especially by large companies to reduce staff in times of slack business. Companies urge workers at 59 or even younger to leave the firm by offering to top up their unemployment benefits to the level of their last net earnings until the employee can draw a pension at 60. Apart from overtime reduction, this became the most important strategy for reducing staff in a comparatively ‘painless’ or peaceful way in large firms with more than 5,000 employees.\(^6\)

As for the reaction of the government to the stagflation of the 1970s, we witness a mixture of cost-cuts and cost-shifting. The net result was a reduction in social spending as a share of GDP, but a simultaneous rise in the share of social expenditure financed from social insurance contributions. The consequence was an increasing cost burden on labour.

One of the major factors responsible for the increasing cost burdens on wages has been the federal and state governments’ retreat from financing welfare expenditures. This is shown in Table 1, which presents sources of welfare revenue over the last three decades. The shift in the financial shares can be the result either of the redefinition of programme responsibilities (for example, if benefits for the very long term unemployed are paid not by tax-financed social assistance but by contribution-financed unemployment insurance), or by simply cutting transfers from the federal budget to the social insurance budgets or by the introduction of new programmes or the extension of entitlements which are primarily or entirely financed out of contributions (for example, the introduction of long term care insurance which substitutes for social assistance payments to the frail and elderly; see below). Finally, it is possible that programmes without government participation grow more costly due to increasing demand or above average inflation.

The effect of German federalism can also be read from Table 1 since it shows quite clearly that not only the federal government, but the Länder as
TABLE 1
SOURCES OF THE SOCIAL BUDGET, 1970–97

<table>
<thead>
<tr>
<th>Year</th>
<th>Federal government</th>
<th>States</th>
<th>Local authorities</th>
<th>Private households and others</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td>23.6</td>
<td>13.7</td>
<td>6.7</td>
<td>56.0</td>
</tr>
<tr>
<td>1975</td>
<td>24.5</td>
<td>12.3</td>
<td>7.2</td>
<td>56.0</td>
</tr>
<tr>
<td>1980</td>
<td>22.4</td>
<td>11.5</td>
<td>7.2</td>
<td>59.0</td>
</tr>
<tr>
<td>1985</td>
<td>20.4</td>
<td>11.1</td>
<td>7.7</td>
<td>60.9</td>
</tr>
<tr>
<td>1990</td>
<td>18.7</td>
<td>10.2</td>
<td>7.8</td>
<td>63.3</td>
</tr>
<tr>
<td>1991</td>
<td>19.7</td>
<td>10.1</td>
<td>8.0</td>
<td>62.2</td>
</tr>
<tr>
<td>1995</td>
<td>19.9</td>
<td>9.9</td>
<td>8.9</td>
<td>61.4</td>
</tr>
<tr>
<td>1997</td>
<td>19.5</td>
<td>10.8</td>
<td>8.6</td>
<td>61.1</td>
</tr>
</tbody>
</table>

Notes: The data given refer to West Germany until the first half of 1990, thereafter to Germany. Data for 1995 are estimated and for 1997 forecasts.


TABLE 2
FINANCING STRUCTURE OF THE SOCIAL BUDGET, 1970–97

<table>
<thead>
<tr>
<th>Year</th>
<th>Contributions</th>
<th>General taxation</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td>58.4</td>
<td>39.7</td>
<td>1.9</td>
</tr>
<tr>
<td>1975</td>
<td>58.8</td>
<td>39.2</td>
<td>1.9</td>
</tr>
<tr>
<td>1980</td>
<td>62.8</td>
<td>35.9</td>
<td>1.4</td>
</tr>
<tr>
<td>1985</td>
<td>64.9</td>
<td>33.5</td>
<td>1.5</td>
</tr>
<tr>
<td>1990</td>
<td>67.5</td>
<td>30.9</td>
<td>1.7</td>
</tr>
<tr>
<td>1991</td>
<td>66.3</td>
<td>32.0</td>
<td>1.7</td>
</tr>
<tr>
<td>1995</td>
<td>65.9</td>
<td>32.6</td>
<td>1.4</td>
</tr>
<tr>
<td>1997</td>
<td>65.2</td>
<td>33.2</td>
<td>1.6</td>
</tr>
</tbody>
</table>

Notes: see Table 1.


well were successful in reducing their share of social spending. The states apparently did not use their veto position in the German upper house, the Bundesrat, to advocate and protect the interests of local authorities, which have come to bear an ever increasing part of social spending. However, the shifts in the relative shares of welfare state financing have been most unfavourable for employers and employees, as shown in Table 2.
The same response pattern of the German political economy that was observable in the wake of the first oil crisis occurred again at the beginning of the 1980s when another oil-price shock led to declining employment in industries and rising inflation. Again, the welfare state became the prime means of economic adjustment and the Bundesbank, as in the early 1970s, stuck to a hard currency policy and urged the Federal Government to consolidate its budget in the midst of the economic slump. Again, as ten years before, the strict monetarist course of the Bundesbank was provoked by the fact that the recession met with an expansionary fiscal policy. The G-7 Bonn summit in 1978 had ascribed to Japan and Germany the role of economic ‘locomotives’ that were to pull the world economy out of recession. When in 1980 the ensuing expansionary fiscal policies met the increasing oil bill in the wake of the OPEC II crisis, Germany had its first current account deficit for 14 years. The Bundesbank soon considered the ‘locomotive experiment’ as a failure and tried to maintain a strong external value of the DM despite Germany’s deteriorating current account balance. The bank stuck to its restrictive policy until the trough of the recession had been passed in 1983.

The restrictive policy of the German central bank in a time of high real interest rates encouraged the government to follow a course of budget consolidation. Finally, the Social Democratic/Liberal coalition encountered irreconcilable positions with regard to the ‘right’ budgetary policy and to the necessity of further cuts in social spending. Nevertheless, it was still under Chancellor Schmidt that the shift to a more restrictive fiscal policy took place. The best known package of cuts was the so-called ‘Budget Operation 82’. When the Kohl government came to power it shelved expansionary policies altogether and embarked on a policy of consolidating the budget with the intention to reduce taxation thereafter. It claimed that it would do so mainly by curbing public and especially social expenditure. Furthermore, the new government wanted to reduce public ownership in industry and deregulate labour markets.

With the help of revenue from privatisation and transfers from the Bundesbank, the centre-right government under Chancellor Kohl was quite successful in reducing the public deficit. Revenue from privatisation and the central bank’s transfers were clearly helpful, but not enough to achieve both lower taxes and a balanced budget at the same time. Therefore, the government sought simultaneously to cut especially social spending – both through ‘real’ cuts and through cost shifting. Cost shifting led to a further increase in contribution rates, which grew even after the economy had gained strength again in the second half of the 1980s. This is explained by
the fact that the government in the second half of the 1980s used the better financial situation of the social insurance budgets to expand programmes again. These were now especially designed to take care of those who had been left unemployed by the previous crisis and had very poor prospects for re-employment, in particular older workers.

With the budget deficit decreasing, tax reform became a political priority towards the end of Kohl's second term, in the late 1980s, for which the CDU/FDP coalition was even prepared to accept somewhat higher deficits. Most unfavourably, the revenue losses caused by the tax reforms occurred at the time when additional layouts for the GDR became necessary. The resulting deficit further fuelled the boom that had developed in the late 1980s and led to an overheating of the economy. Clearly, the Kohl government had departed from its consolidation policy of the 1980s in the face of the demands resulting from the fall of the Berlin Wall and the forthcoming general elections in December 1990.

In its effort to balance its budget and later to provide taxpayers and the electorate with tax relief, the government had largely neglected the financial problems of the welfare state. There is no doubt that cost containment did happen and that it was relatively successful in keeping social expenditure as a share of GDP more or less constant. Yet cost containment did not prevent a further rise in social insurance contribution rates. This was because the federal state had increasingly reduced its financial share since the onset of the crisis. In fact, this was a secular trend from the mid-1970s on, but which accelerated during the crises of the early 1980s and 1990s (see Table 1). The gap caused by the federal and state governments' steady withdrawal from its share of funding the welfare state finally had to be made up from other sources, primarily social insurance contributions. In Figure 1, the actual development of social insurance contribution rates is shown against what they would have been if the share of contributions in overall welfare financing had remained at the 1970 level. Until 1975, actual and counterfactual contribution rates grew in line. At the eve of unification in 1990, however, the share financed from contributions had risen from 58 per cent in 1970 to 67 per cent. Had shares stayed the same, contribution payers would have saved an aggregate of DM70 billion and the contribution rate could still have basically remained at its 1975 level.

Shifting costs on to the insurance schemes results in higher non-wage labour costs for the individual. Looking at the income level of an average production worker, we indeed find that social insurance contributions and other taxes have made up a rapidly increasing share of total labour costs. According to Figure 2, Germany ranks second in this respect, only
FIGURE 1
ACTUAL AND COUNTERFACTUAL CONTRIBUTION RATES (1970–97)

FIGURE 2
TAX WEDGE IN GERMANY, BELGIUM, AND THE OECD (1979–97)
<table>
<thead>
<tr>
<th>Country</th>
<th>Tax Wedge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>49.5</td>
</tr>
<tr>
<td>Sweden</td>
<td>49.2</td>
</tr>
<tr>
<td>Italy</td>
<td>48.8</td>
</tr>
<tr>
<td>Germany</td>
<td>47.7</td>
</tr>
<tr>
<td>Finland</td>
<td>44.2</td>
</tr>
<tr>
<td>Denmark</td>
<td>41.7</td>
</tr>
<tr>
<td>France</td>
<td>41.6</td>
</tr>
<tr>
<td>Austria</td>
<td>41.1</td>
</tr>
<tr>
<td>Netherlands</td>
<td>38.8</td>
</tr>
<tr>
<td>Norway</td>
<td>34.3</td>
</tr>
<tr>
<td>USA</td>
<td>29.2</td>
</tr>
<tr>
<td>UK</td>
<td>28.4</td>
</tr>
<tr>
<td>Canada</td>
<td>27.9</td>
</tr>
<tr>
<td>Switzerland</td>
<td>27.3</td>
</tr>
<tr>
<td>Ireland</td>
<td>24.9</td>
</tr>
<tr>
<td>New Zealand</td>
<td>20.3</td>
</tr>
<tr>
<td>Australia</td>
<td>19.4</td>
</tr>
<tr>
<td>Japan</td>
<td>19.4</td>
</tr>
</tbody>
</table>

Notes: Employees' and employers' social security contributions and personal income tax less transfer payments as a percentage of gross labour costs, single individual at 67 per cent of average production worker wage level, 1997.


surpassed by Belgium. Table 3 shows that this finding also holds at lower income levels. At an earnings level of 67 per cent of the average production worker, the tax wedge, that is, the difference between gross labour costs and net wages, is also among the highest in the OECD. This is especially so for lower wages, where social insurance contributions are salient since they are usually levied from the first unit of earnings, but only up to a certain ceiling. Income taxes, by contrast, often have personal allowances but tax all income beyond this level. High tax burdens at low incomes are even more problematic for employment than at higher levels, a point we will come back to.

In the following section we will give a more detailed account of the various social policy measures enacted in the 1980s and 1990s that made up for most of the pathologic adjustment from which the German economy suffers today. The particular impact of unification on the welfare state and the German labour market will be described subsequently.

FIRMS, THE STATE AND THE REDUCTION OF LABOUR MARKET SUPPLY

The prima facie highly contradictory course of social policy in the 1980s that saw both the attempt to retrench social spending and the substantial expansion of entitlements appears less incoherent if interpreted against the background of the business cycle. The government’s response to economic recessions follows two partly conflicting objectives, namely to contain the growth of social spending and to help firms to cope with the economic crisis by offering them the opportunity to lay off workers ‘painless’ via welfare state programmes. The trade-off between both objectives was partly solved...
by ‘policy sequencing’. This leads to the same pro-cyclical policy profile that we can also observe in the area of active labour market policy (see below): cutbacks in times of economic slump – in order to ease the financial pressures on the public budget – were followed by the considerable extension of entitlements and eligibility during booms, in order to help those that were left unemployed by the last recession. These latter extension measures then become especially important for the response to the next crisis.

Thus it is no surprise that it was the social entitlements which had been granted in the past in times of brighter economic prospects which came to be especially important for the response of the German welfare state to the recession in the first half of 1980s. The first policy reaction to the second OPEC crisis comprised the enactment of a number of cutback measures that either sought simply to contain costs (for example, reduction of the unemployment benefit levels in 1983) or that sought to make the entry into early retirement less attractive for workers and firms (for example, the introduction of more restrictive qualifying criteria for the disability pension in the budget law of 1984). Also in the last category falls the introduction of the Early Retirement Act (Vorruhestandsgesetz, 1984), which was enacted with the intention to substitute it for the more costly 59er rule – that is, pensions linked to long-term unemployment. Already in 1982 the government had forced firms to pay back unemployment benefits that the Labour Office paid to formerly long-term employed workers who had been dismissed at the age of 59. Two years later employers were also forced to repay pension and health insurance contributions that the Labour Office had paid on behalf of these unemployed. However, firms were quick to challenge this new provision before the courts and in the end employers’ repayments turned out to be rather insignificant. Thus, while the 59er rule is still a frequently used pathway into retirement, the Early Retirement Act expired in 1988 and has been succeeded only by an even less successful programme. The employers’ obligation to pay back social insurance contributions paid by the Labour Office was abolished altogether in 1991. The numbers of unemployment pensions steadily increased from the mid-1980s and skyrocketed in the wake of the unification crisis in the early 1990s. The meagre results of the fight against an ever earlier exit from the labour market reflects the ambivalence of the government’s position. On the one hand, the use of pension policy as an instrument of labour supply control promised to ease labour market pressures and was in the foremost interest of both unions and employers. On the other hand, pensions because of long-term unemployment were a very costly instrument of ‘passive labour
market policy. Moreover, efforts to restrict access to early retirement were pursued only half-heartedly since the economy seemed slowly to pick up again in 1984.

While the attempts to reverse the trend of an ever earlier exit from work did not add up to much, the extension of entitlements introduced once the crisis seemed to be over and once social insurance budgets were in surplus again had much more of a long-term impact. In the second half of the 1980s, in an economically more favourable period, one of the more important measures was certainly the considerable extension of the period in which unemployment benefits for workers of 54 and over were paid out. From 1987, these workers have been eligible for the regular unemployment insurance benefit (unemployment benefit – Arbeitslosengeld) for up to 32 months. Ever since 1927 and until as late as 1985, the maximum duration had been only 12 months. Given the longer eligibility for unemployment benefits, workers could now exit the labour market at the age of 57 and then draw a pension because of long-term unemployment from the age of 60. The 59er rule effectively became a 57er rule. Moreover, workers aged 58 and over did not have to be at the Labour Offices’ permanent disposal. These workers did not appear thereafter in the unemployment statistics.

The overall effect of these various measures was a decline in the labour force participation of the 55–65 age group. When we look at the more active attempts to deal with the labour market problems of the 1980s, we observe the same pro-cyclical logic as with early retirement. Since active labour market policies in Germany are financed from unemployment insurance contributions, the fund quickly runs into financial difficulties in a recession: the payment of unemployment benefits increases while at the same time revenue deteriorates. The government then faces the choice of either subsidising the insurance fund or cutting expenditure. Since there are no legal entitlements to training or work creation measures, and given the Bundesbank’s disciplinary pressures towards the consolidation of the public budget, these programmes become a natural candidate for cost cuts. This was clearly the case when the Social Democrats curbed spending in the 1975 Budget Act. Once the recession is over, the financial situation of the insurance fund improves again and those still unemployed exhaust their insurance benefits and have to rely on unemployment assistance, which is financed from the federal budget. This turns the incentive structure around as the government can now shift part of the financial burden back into the insurance fund by introducing new work-creation schemes.
The same pro-cyclical policy pattern was observable in the early 1980s in the wake of the OPEC II crisis. Active labour market measures were scaled down with the 1981 amendment to the Employment Promotion Act. After unemployment insurance was back in surplus and the recession seemed to have passed in 1985, the cuts were partly reversed. Nonetheless, labour market policy was quite active during this time and clearly contributed to the lowering of unemployment. But since training is contribution-financed, the pro-cyclical shifts from programme contraction to programme expansion prevented social insurance expenditures from decreasing and contribution rates from falling once the economic crisis was over. The business-cycle responsiveness of the German welfare state is thus skewed, asymmetric: economic downturns and the accompanying deficits provoke semi-successful programme cutbacks, cost shifting as well as instant contribution rate increases. During booms the contribution rates remain high and stable. The resulting revenue surplus is either used for post-crisis welfare expansion, especially targeted at the long-term unemployed who have exhausted their benefits in the meantime, or to finance the federal government’s retreat from funding the welfare state. With this higher level of spending and revenue, but also with more generous welfare entitlements, the welfare state then enters the next crisis. Thus, we witness a ratchet-effect that parallels the rise in unemployment. In each recession, insurance contributions are raised but do not fall back to their initial level with the recovery.

Although it represented an extraordinary and unique ‘external shock’, German unification triggered the same, by now familiar, policy sequence: initial fiscal expansion is brought to a rather abrupt halt by the monetarist intervention of the German central bank. In the ensuing crunch, the social partners and the federal government use the welfare state as a buffer for both the financial and labour market pressures with which they are faced. In the following section we show how this sequence unfolded – and with what consequences – in the early 1990s.

A ROUTINE RESPONSE TO A NON-ROUTINE SITUATION: GERMAN RE-UNIFICATION

The two decisions that proved to be most significant for the fate of the east German economy were the fixing of an unrealistic conversion rate between the east German currency and the D-Mark and the attempt of the social partners to replicate the west German high wage/high productivity regime in the east. Fierce party competition due to the numerous state and general elections in 1990 combined with the intensive efforts of west German
corporate actors to preserve the western status quo resulted in a straightforward transfer of the west German institutional setting to the east. As was soon to become clear, this strategy had devastating consequences.

In spite of widespread warnings, the DM replaced the east German currency at a conversion rate largely out of line with purchasing power parities. Literally overnight, eastern industries became uncompetitive. The immediate result was a drastic surge in unemployment. At a time when the effects of this disastrous decision were already being felt, the metal workers union pressed for an agreement aimed at the rapid reduction of wage differentials between east and west. As a consequence, unit labour costs in the east shot up to levels that were way above those prevailing in the west. Considering that even the west German manufacturing sector had severe competitiveness problems at the beginning of the 1990s, this can explain the ensuing terrible employment losses in the manufacturing sector in the former GDR. Employment began to decline sharply as early as 1990 in all sectors that were exposed to western competition. Between 1991 and 1993, total employment shrank by 15 per cent and manufacturing employment fell by some 45 per cent. Of course, an economic catastrophe of these dimensions affected public finances and the welfare state. Budget deficits rose quickly and added to public debt, which had already grown substantially, given that the debt of the former GDR was absorbed by the united Germany.

Even in the face of such an extraordinary challenge as unification, the Bundesbank continued to follow its tight monetary policy. The bank had been already very uneasy about the rate at which the GDR's currency was converted into Deutsche Mark, but was unable to do more than voice its

### TABLE 4

<table>
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<tr>
<th>Year</th>
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<th>Debt</th>
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<tbody>
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<td>-3.3</td>
<td>60.5</td>
</tr>
<tr>
<td>1996</td>
<td>-3.4</td>
<td>63.0</td>
</tr>
<tr>
<td>1997</td>
<td>-2.6</td>
<td>63.6</td>
</tr>
<tr>
<td>1998</td>
<td>-2.0</td>
<td>63.1</td>
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**Notes:** Deficit (-) refers to general government financial balances as a percentage of nominal GDP. Debt refers to general government gross financial liabilities as a percentage of nominal GDP. From 1994 onwards it includes the debt of the German Railways Fund and the Inherited Debt Fund from 1995.

concerns. From the very beginning, the German central bank had also signalled that it would not accept deficit financing of the unification process beyond a level that could be justified by initial ‘unexpected burdens’. Furthermore, the bank was worried about the high wage increases that were struck in the immediate post-unification boom. It signalled to the federal government and to the unions that it was unwilling to accommodate their expansionary policies. In December 1991 the bank rate and the Lombard rate were raised to a new post-war record level and about half a year later the bank rate was raised even further. The Bundesbank raised interest rates at a time when recession was already in sight and thereby hardly cushioned the downturn. The unification boom in the west ended in a deep recession at a time when the eastern economy had hardly recovered from the immediate post-unification recession. With the Deutsche Mark as the anchor of the European Monetary System, the Bundesbank’s policy also had international repercussions. Other European countries had either to raise their interest rates to German levels or were forced out of the system. Eventually, major European countries that had pegged their currency to the DM had to defend parity or suspend it. Consequently, the DM appreciated even further. The high wage increases aggravated the competitiveness problem of German industry, leading to major employment losses in the west German export industries. Finally, the Bundesbank started to reduce interest levels, albeit in many small steps.

The federal government had strongly underestimated the costs of unification and overstated revenue especially from the sale of the Treuhand companies, that is, the privatisation of the formerly state-owned companies in the east. This was a mixture of wishful thinking and ‘strategic optimism’ related to the approaching general elections in 1990. Things turned out quite differently. Instead of a renewed economic miracle, a depression devastated the east and the public budget went deep into deficit. The privatisation of the Treuhand companies became a burden rather than a boon for the federal budget. To make things even worse, the government had committed itself just before the elections to a no tax-raise policy in an attempt to make the public believe that current income would suffice to cover the costs of unification. In 1991, expenses could still be covered partly through additional tax revenues from the boom in the west. The remainder had to be financed out of borrowing. Given the policy of the Bundesbank, however, this quickly came up against difficulties. The government had to renege on its ‘no tax-rise’ commitment: the Solidarity Law and the Tax Amendment Act as of June 1991 introduced a temporary 7.5 per cent surcharge on personal and corporate income tax, increased
some excises and provided the new Länder with temporary special tax expenditure allowances. However, these allowances, which were intended to promote investment in the new Länder, reduced the price of capital in relation to labour. In consequence, western companies placed highly capital-intensive production sites in the new Länder, which, of course, did not make a substantial impact on unemployment. Moreover, the tax allowances became a major fiscal loophole that decreased revenue from assessed income tax.

The public deficit increased again to 3.2 per cent of GDP in 1993 as economic growth turned negative; but even after economic recovery in 1994 the deficit remained high since tax revenue did not grow in line. It was only in 1995 that the underlying erosion of the tax base became apparent. Despite the solidarity surcharge, tax revenue grew less than nominal GDP due to the rapid decrease of assessed income tax and the corporate tax. The former declined between 1992 and 1996 from DM41.5 billion to DM11.5 billion! This was mainly due to the above mentioned generous tax exemptions for investments in the new Länder. The decline of corporate income tax was less pronounced but developed against a background of increased company profits. In this case tax competition may well have played a role.

At a time when increased deficits were ruled out and revenue from corporate and personal income taxes stagnated or even decreased, while a reduction in the expenditure for the east was impossible as well, it became tempting to finance unification via social insurance. This is exactly what happened. It has already been pointed out that the social insurance schemes were financially in pretty good shape at the beginning of the 1990s. Initially, they could support the increased burdens imposed by unification without immediately running into deficits. Unemployment insurance was most rapidly hit by the collapse of the east German labour market. The government raised the contribution rate by 2.5 percentage points in 1991. The additional expenditure for the east in that year amounted to some DM30 billion, of which only DM5 billion could be met out of the federal subsidy. The remaining deficit of DM25 billion had to be financed by contributions in the west.

Health insurance was also, albeit indirectly, used to cover expenditures which otherwise would have to be paid for by the federal budget. Cutting payments from unemployment insurance to the sickness funds which provide health insurance for the unemployed helped reduce the deficit in the unemployment insurance that had to be covered out of the central budget. This again saved the government money. Finally, the government shifted the burden onto the pension scheme. In 1992, the pension scheme of the GDR
was integrated into the western system, two years in advance of the date that had initially been agreed upon. This meant that west German contributors now covered deficits in the east that resulted from the gap between pension revenue and spending under the all-German pension scheme.\textsuperscript{43} It has been calculated that the west German pension schemes would have run surpluses that could have even made a reduction in contribution rates possible if the money had not been spent on the revenue gap in the east. The same goes for unemployment insurance.\textsuperscript{44} While the government was successful in shifting the burden into other budgets, the money had to come from somewhere. The consequence was rapidly rising contribution rates.

This trend was not counteracted by the Health Reform Act of 1993 (Gesundheitsstrukturgesetz), which could no more than flatten the slope of the growth trend in expenditures and contribution rates. However, despite the precarious state of public finance and the poor labour market performance, even expansionary steps in social policy appeared possible. The introduction of Long-Term Care Insurance (LTCI) in 1994 seemed to go against the trend to cut back welfare spending and to lower entitlements and coverage of welfare programmes. The introduction of LTCI appears to be less surprising, however, if one considers that the main financial burden was once again placed on contribution payers. In fact, the LTCI even reduced public social spending because the insurance partially replaced social assistance payments to the old and frail that were previously covered by the local authorities.\textsuperscript{45} While LTCI had some positive employment effects (creating an estimated 67,000 new jobs\textsuperscript{44}), the net effect is significantly smaller due to the detrimental impact of increased non-wage labour costs.

The welfare schemes had to bear the brunt of adjustment in the labour market as well. In the west we basically find the familiar adjustment pattern: new cohorts of older workers continued to leave the labour market. The pension reform of 1989, which took effect in 1992, did not substantially restrict access to early retirement: the introduction of a higher retirement age was to be only slowly phased in from 2001. Hence the impact of the reform was marginal and early retirement remained the most important response to the crisis. Work creation in the west never regained the importance that it had in the late 1980s, despite increasing unemployment in the recession. This seems to be a consequence of the large shift of resources to the east. Vocational training, by contrast, has remained quite stable.

Turning to the east, it is clear that the huge west German welfare state had to buffer the economic shock. Once a functioning labour market administration had been established in 1991 in the five new states, early retirement
became widely used. The first pre-retirement provision had already been introduced by the last Communist Modrow government and was included in the Unification Treaty. About 400,000 older workers in east Germany made use of this pre-retirement provision. The Unification Treaty replaced this scheme – which had to be financed out of the federal budget – by a new scheme (Altersübergangsgeld) with very similar benefits but financed by the Federal Employment Office. Around 600,000 workers used this scheme. As an effect of these and other early retirement programmes, the labour force participation of older eastern workers fell to extremely low levels.

However, given the scale of the labour market disaster in eastern Germany, early retirement programmes alone could not do the job. Active labour market policy was extended to unprecedented lengths. Employment in work-creation schemes has been at least twice as high in the east as in the west in every year since 1991, although the working-age population in the new Länder is only about a fifth of that of the west. In contrast to the situation in the old Länder, work creation schemes were often used to improve eastern infrastructure. Since such investments are quite expensive, the federal government subsidised these schemes in the first two years of their existence. When budgetary pressures intensified, the government curbed spending. Consequently, employment in these schemes fell by 60 per cent in the following years, interrupted only by a short-lived upturn just before the 1998 elections. The expansion of both active as well as passive labour market policy led to a further increase in social insurance contributions. In the following final section we briefly discuss the effects this had on labour market performance and economic competitiveness.

WELFARE AND WORK: SOCIAL INSURANCE AND EMPLOYMENT

It has been pointed out repeatedly that in Germany the fate of social insurance is closely linked to the development of employment, since gross wages are the financial base of the German welfare state. Although less obvious, the reverse is also true. Employment in Germany began to decline in the early 1990s and has continued to do so in both parts of the country. While this has clearly put social insurance under financial strain, the very same schemes may well be part of Germany's unemployment problem.

Rising insurance contributions do not affect employment as long as employers are able to turn over the burden to the employees (or to consumers), which are then faced with a (real) net wage decline. If employees or the unions successfully defend (real) net wage levels, labour...
costs rise. This, of course, has adverse employment effects. As Tyrväinen has shown, real wage resistance is indeed very high in Germany. Another study conducted by Bauer and Riphahn also concludes that the rise in social security contributions has led to higher real wages and consequently had negative employment effects. These findings explain why employers and employees increasingly search for legal loopholes that would free them from the obligation to pay the ever higher social insurance contributions. An increasing number of companies try to avoid paying contributions by classifying their workers as 'self-employed'. This practice is particularly widespread among workers with average or above-average wages (for example, journalists or marketing experts), but also increasingly used in home-delivery, cleaning or transportation. The impact of rising social insurance contributions at this lower end of the wage scale is even more problematic. Here, the net wage often cannot fall in response to higher non-wage labour costs, given that wages would then fall below the level of unemployment benefits or social assistance. One consequence is that many low-productivity jobs become unprofitable and are either replaced with more capital-intensive production methods or are not created in the first place. The upshot is poor job growth and below-average employment in the German service sector. Until recently, employers and employees could also avoid paying insurance contributions through the use of a special provision that exempted employment contracts of less than 15 hours a week and DM 630 a month from paying contributions. There is considerable uncertainty as to how widespread this non-regular form of employment has become, with estimates ranging from 1.6 to 5.4 million jobs. But all available empirical evidence shows that there has been a sharp increase in the number of these non-standard jobs since the early 1990s. This again indicates that increasing non-wage labour costs, in particular rising social insurance contributions, do pose a serious problem. It is our contention that Germany's unemployment problem is closely related to the steady upward trend in non-wage labour costs caused by the increase in the welfare cost burden put on labour. The increase in labour's cost share, in turn, is a consequence of the tendency of both firms and the state to externalise the costs of economic and financial adjustment to economic crises onto the contribution-financed welfare state.

In putting our argument in perspective, two final remarks are in order. First, when assessing in comparative terms how pathological Germany's 'pathological adjustment' really is, it is necessary to make certain implicit normative judgements explicit. In fact, we do not think a basic shortcoming of the contemporary German Standort debate is that it ignores the fact that
mass unemployment occurs in other European countries as well. That many other countries of continental Europe share Germany’s problem of very poor labour market performance provides little comfort in our view for ‘the median’ (Germany) within this miserable group. Mass unemployment is not less of a social scandal if it also occurs somewhere else.

In this study we have confined ourselves to identifying the basic mechanisms that have prime responsibility for the German ‘welfare-without-work’ dilemma. We have tried to explain why high structural unemployment might be a strategic equilibrium given the incentives of Germany’s political and economic order and the interests of the key actors: employers, unions and the state. Yet, it should be clear that we do not think the cost-shifting game we have described has been inevitable or is irreversible. Quite the contrary. A number of political initiatives, some of which were already undertaken by the former CDU/FDP government, have tried to lower social insurance contribution rates mainly by increasing again that part of welfare spending financed from the central budget, that is, out of general taxation. Yet, in showing how long the shifting of welfare costs to the expense of labour has been going on, our analysis can help highlight how problematic and politically difficult a trend reversal will be – especially in times when taxation has become pretty much a depleted resource. In our view, the current turmoil in German politics indicates that while the traditional strategies of economic adjustment have become disadvantageous for the key actors responsible, the search for alternatives remains costly and conflict-ridden.

NOTES

2. Translation: ‘business location Germany’.


10. For instance, acceptability criteria in German unemployment insurance hold that unemployed persons have to accept only those jobs whose pay does not fall below the level that has been agreed upon by unions and employers in collective bargaining. See K.-H. Pfaü, 'Unemployment and the Crisis of the German Model: A Long-Term Interpretation', in H. Giersch (ed.), *Fighting Europe's Unemployment Problem* (Berlin: Springer 1996), pp.123-55.


21. The Pre-Retirement Act introduced the opportunity for employers to lay workers off at the age of 58 (the so-called 58er rule) and to pay them for between two (women’s retirement age: 60) and five years (‘flexible retirement’ age for men: 63) at least 65 per cent of their last net wage. At the same time, the law provided a public subsidy of a maximum 35 per cent of the retirement wage if the vacant position was filled by a registered unemployed or a trainee for at least two years. However, early retirement did not stir up a lot of excitement among employers and workers since it was more costly for employers and offered less generous benefits for workers. The take-up rate was rather modest, with about 165,000 workers between 1984 and 1988 when the act expired. The substitution rate has been estimated to have been about 80 per cent, thus producing a maximum of 135,000 new jobs. See K. Jacobs, M. Kohli and M. Rein, 'Germany: The Diversity of Pathways', in M. Kohli, A.-M. Guillemand and H. von Gunsteren (eds.), *Time for Retirement. Comparative Studies of Early Exit from the Labor Force* (New York: Cambridge University Press 1991), pp.181-221. J.


23. The Federal Office of Labour had a budget surplus of 3.1 and 2.3 billion DM in 1984 and 1985 and a marginal deficit of 0.2 billion DM in 1986. In the years between 1983 and 1988 the government did not need to cover deficits of the Federal Office with state subsidies.


34. A holding owned by the federal government that comprised a large part of the GDR's economy.


39. Ibid., pp.92-3.


41. Moreover, in some cases the recalculation of east German pensions in line with west German law led to lower pensions as compared to the old entitlements in the GDR. The difference was then made up by an additional transfer (Auffüllbetrag) until 1995. According to the Deutsche Bundesbank, 'Die Finanzentwicklung der gesetzlichen Rentenversicherung seit Beginn der neunziger Jahre', *Monatsbericht der Deutschen Bundesbank* 47/3 (March 1995), p.22, it amounted to DM6 billion a year. This sum again had to be covered mainly by contributions.


43. J. Alber, 'Paying for Long-Term Care in a Social Insurance System: The Example of


45. The increasing internationalisation, or in the case of Germany, Europeanisation of markets has made it near impossible simply to add national increases in production costs to prices.
