

# Economic Reform and the Political Economy of the German Welfare State

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*The central problem of the German economy is the high costs of labour, driven up by the burden of funding an extensive welfare state through social insurance contributions that operate as payroll taxes on employment. The study identifies the political causes of the long-term rise in non-wage labour costs. It analyses the reforms of the last decade, showing how the multiplicity of veto points in the German political economy has weakened reform initiatives and reduced the prospect for effective reform in the foreseeable future.*

Contrary to widespread belief, the German economy does not suffer from a lack of international competitiveness.<sup>1</sup> Despite the high value of the euro, the trade surplus continues to rise. Employment in exposed sectors, while declining as elsewhere, continues to exceed that in any comparable country, indicating that German industry has maintained its outstanding competitive performance. Industrial wages are high, but are offset by high and fast-rising productivity.<sup>2</sup>

Nor does the German economy face particular difficulties with respect to internationalisation. Notwithstanding employment protection, co-determination and high wage levels, inward foreign investment remains buoyant, attracted by an excellent infrastructure, a high skill workforce and peaceful labour relations.<sup>3</sup> German firms have substantially expanded their activities abroad in order to compete for market share. During the past decade, firms like Siemens, BASF, BMW, Volkswagen, Daimler-Benz, and Hoechst, have evolved into true multinationals. Well into the 1990s, the domestic employment effects of outward investment have been generally benevolent. A decline in low-skilled jobs has been compensated by growth in high-skilled employment, resulting in an upgrading of the employment structure with only minor losses in the volume of employment.<sup>4</sup>

Nevertheless, there is a severe and worsening employment problem, and it is here that an analysis of malfunction in German economic institutions must begin. For almost two decades now, high unemployment has been combined with low participation in the labour market, resulting in a remarkably low *rate of employment*. Given that employment in industry is above the international average, the explanation is low employment growth in services, especially domestically traded services.<sup>5</sup> While this has long been known, it has been largely neglected for a number of reasons. Above all, many of those outside employment have been supported by comparatively liberal unemployment benefits, or attractive early retirement terms.<sup>6</sup> Others were kept out of the labour market by extended periods of education.<sup>7</sup> Moreover, a low rate of female participation

in the labour market turned the family into another holding pen for those unlikely to find employment in a stagnant labour market.<sup>8</sup>

It is now obvious, however, that the country can no longer afford to treat a low employment rate as a matter of political choice, or as the expression of a national preference for industrial rather than service-sector occupations. Taking surplus labour out of the market on comparatively comfortable terms has become less and less possible due to an endemic financial crisis of the state. The resultant benefit cuts make non-employment increasingly unacceptable to a growing number of people. Not only does this cause political discontent, but it also sets in motion a transformation of the employment system from below, in the form of the emergence – unprecedented in the post-war German economy – of a sizeable number of ‘working poor’.<sup>9</sup>

These problems are compounded dramatically by the slow growth of the German economy.<sup>10</sup> Slow growth contributes to a crisis of public finance that is exacerbated by downward pressure on public revenues resulting from tax competition with other countries and the perceived desire of citizens for tax cuts. Tax cuts coincide with the obligation incurred under European Monetary Union to consolidate public finances, resulting in an apparently unending series of austerity budgets. At the same time, governments at all levels are faced with business demands for a well-developed infrastructure and high levels of education as a condition for continuing to produce in Germany.

There are also indications that Germany is beginning to lag behind other countries in high-technology sectors and high value-added products.<sup>11</sup> Moreover, low-cost competition from potential high-quality producers in Eastern Europe is making it harder for German production sites to compensate for high costs through superior productivity and product quality. In short, not only are the old ways of living with low employment becoming gradually unviable, but the highly productive employment that in the past paid for the pacification of the unemployed may be about to break away at a much faster pace.

Where does an affluent country facing slow impoverishment begin with economic reform? An often-cited suspect is Germany’s vast and expensive welfare state. Indeed, comparative research has produced convincing evidence that it is the particular characteristics of the Bismarckian welfare state – funded through social security contributions and geared to status maintenance rather than protection from poverty – that depresses the level of employment by inflating the costs of labour. High non-wage labour costs interact with unemployment in a vicious circle. By making labour more expensive, they induce firms to downsize their labour force, in the past typically through early retirement. They also prevent employment growth in labour-intensive sectors, especially in services. Alternatively they drive labour into the black economy, reducing the revenues of the social insurance funds, thus pushing up contribution rates. The same effect is caused by unemployment and non-employment, to the extent that individuals are supported by the pension or the unemployment insurance system. As rates rise in response to declining employment or increasing entitlements, labour costs also rise, reducing employment even more. In the end, the very instruments which used to make unemployment socially acceptable become a cause of even more unemployment.<sup>12</sup>

Cutting non-wage labour costs in order to raise employment is, however, not an easy feat to accomplish as it must involve one or more of three things: cuts in the entitlements of future and, especially, current beneficiaries; a shift from public to private provision

paid for by individuals with no contribution from their employers; and a change in the funding base of the welfare state from contributions to taxes. Given the demographics of an ageing population, the same applies in principle when the objective is much less ambitious and involves no more than freezing non-wage labour costs at the current level.

Freezing, however, is clearly not enough. Apart from the fact that it leaves the relationship of mutual reinforcement between high labour costs and low employment intact, it would require growing infusions of tax money that would be urgently needed for investment in the physical infrastructure and in research and innovation. This is another, more recent way in which welfare state compensation for unemployment and low employment contributes to exacerbating the problem that it is supposed to remedy. For example, by the early 2000s the budget of the Federal Labour Office (around €50 billion) was almost double the combined budget of all German universities (about €27 billion).<sup>13</sup> Thus a fundamental precondition for a successful defence of German prosperity is moving resources from the satisfaction of mostly consumptive entitlements into investment in productive capacities. It is for this reason that economic reform must focus above all on the welfare state.

#### THE RISE OF NON-WAGE LABOUR COSTS

The German welfare system consists of four major elements: pension insurance, unemployment insurance, health insurance and long-term care insurance. Whereas pension and unemployment insurance receive federal subsidies, health insurance was until 2003 exclusively funded by contributions, and long-term care insurance still is. Long-term care insurance was introduced in 1995, at a time when the social insurance system was already beginning to crumble under the burden of German unification. The main period of expansion of the German social insurance system was during the heyday of *Modell Deutschland* in the 1970s and early 1980s, the success of which was based on a subtle interaction between the welfare state, the system of collective bargaining and the federal budget.<sup>14</sup> Social security supported the remarkably successful adjustment to declining mass production and later helped the country cope with the socio-economic and political challenges caused by German unification. The latter brought West German welfare standards to East Germans nearly overnight, allaying any political discontent that might have arisen from the dismantling of state socialism.

The West German welfare system responded to the economic crisis after unification by transforming East Germany rapidly into a state-supported secondary labour market and a society of early retirees. Owing to decades of extensive use of the social insurance system to absorb surplus labour created by high wages, low wage dispersion and German unification, combined social insurance contributions steadily increased, and by 1996 they exceeded the magic figure of 40 per cent of gross wages (Table 1). Between 1990 and 1998 alone, the combined social insurance contribution rate grew by six and a half percentage points, from 35.5 per cent to 42.1 per cent, of which German unification accounted for about three percentage points.<sup>15</sup>

One of the typical characteristics of the German social insurance system is its fragmentation into four separate budgets. This allows the government to mask financial difficulties by complex fiscal manoeuvres involving the different para-fiscal social insurance funds and the federal budget. Since the early 1980s, the government has with

TABLE 1  
CONTRIBUTION RATES BETWEEN 1949 AND 2003, AS OF THE END OF THE YEAR

Year	Unemployment	Pension	Health care	Total*	Year	Unemployment	Pension	Health care	Total*
1949	4.0	10.0	6.0	20.0	1977	3.0	18.0	11.4	32.4
1950	4.0	10.0	6.0	20.0	1978	3.0	18.0	11.4	32.4
1951	4.0	10.0	6.0	20.0	1979	3.0	18.0	11.2	32.2
1952	4.0	10.0	6.0	20.0	1980	3.0	18.0	11.4	32.4
1953	4.0	10.0	6.0	20.0	1981	3.0	18.5	11.8	33.3
1954	4.0	10.0	6.2	20.2	1982	4.0	18.0	12.0	34.0
1955	3.0	11.0	6.2	20.2	1983	4.6	18.5	11.8	34.9
1956	3.0	11.0	6.2	20.2	1984	4.6	18.5	11.4	34.5
1957	2.0	14.0	7.8	23.8	1985	4.1	19.2	11.8	35.1
1958	2.0	14.0	8.4	24.4	1986	4.0	19.2	12.2	35.4
1959	2.0	14.0	8.4	24.4	1987	4.3	18.7	12.6	35.6
1960	2.0	14.0	8.4	24.4	1988	4.3	18.7	12.9	35.9
1961	0.0	14.0	9.4	23.4	1989	4.3	18.7	12.9	35.9
1962	1.4	14.0	9.6	25.0	1990	4.3	18.7	12.5	35.5
1963	1.4	14.0	9.6	25.0	1991	6.8	17.7	12.3	36.8
1964	1.3	14.0	9.7	25.0	1992	6.3	17.7	12.5	36.5
1965	1.3	14.0	9.9	25.2	1993	6.5	17.5	13.2	37.2
1966	1.3	14.0	10.0	25.3	1994	6.5	19.2	13.3	39.0
1967	1.3	14.0	10.1	25.4	1995	6.5	18.6	13.1	39.9
1968	1.3	15.0	10.2	26.5	1996	6.5	19.2	13.7	41.1
1969	1.3	16.0	10.5	27.8	1997	6.5	20.3	13.4	41.9
1970	1.3	17.0	8.2	26.5	1998	6.5	20.3	13.6	42.1
1971	1.3	17.0	8.2	26.5	1999	6.5	19.5	13.6	41.3
1972	1.7	17.0	8.4	27.1	2000	6.5	19.3	13.6	41.1
1973	1.7	18.0	9.2	28.9	2001	6.5	19.1	13.6	40.9
1974	1.7	18.0	9.5	29.2	2002	6.5	19.1	14.0	41.3
1975	2.0	18.0	10.5	30.5	2003	6.5	19.5	14.3	42.0
1976	3.0	18.0	11.3	32.3					

\*Total: from 1995 including long-term care. Until June 1996 the contribution rate was 1.0 per cent. In July 1996 it increased to 1.7 per cent.

Source: 1949 to 2002: 'Christine Trampusch, Ein Bündnis für die nachhaltige Finanzierung der Sozialversicherungssysteme: Interessenvermittlung in der deutschen Arbeitsmarkt- und Rentenpolitik', *MPIfG Discussion Paper 03/1* (Köln: Max-Planck-Institut für Gesellschaftsforschung, 2003); for the data on health insurance in 2002 and 2003: BDA, Beitragssätze zur Sozialversicherung, [http://www.bdaonline.de/www/bdaonline.nsf/id/GraphikBeitragssaetzezurSozial/\\$file/Beitragssätze.pdf](http://www.bdaonline.de/www/bdaonline.nsf/id/GraphikBeitragssaetzezurSozial/$file/Beitragssätze.pdf) (6 Dec 2004).

increasing skill hidden rising contribution rates and avoided spending cuts by means of financial transfers between the social insurance funds and by infusing federal tax money into the social insurance system. For example, in 1977 the government made the unemployment insurance fund pay pension contributions for recipients of unemployment benefit. It was thus able to keep the pay-as-you-go pension system liquid without an increase in the contribution rate, at the price of creating additional future entitlements. Similarly, from 1992, the unemployment insurance fund has to pay pension insurance contributions for participants in job creation measures in eastern Germany. While this increased the revenue of the pension insurance fund, it caused a long-term increase in unemployment insurance contributions. Moreover, to stabilise the combined social insurance contribution rate between 1981 and 1991, the government several times balanced a rise in one contribution rate by lowering another, causing long-term fiscal problems for those systems whose contribution rates were lowered.

A second means of avoiding increased contributions was to subsidise social budgets through federal grants to the pension and unemployment insurance funds (Table 2) and by federal transfers of benefits not calculated according to actuarial principles. Between 1981 and 2003, federal support for the pension insurance system increased from 18 to 26 per cent of the latter's total revenue (€14 to €61 billion; Table 2). In 1993, the then Bundesanstalt and now Bundesagentur für Arbeit, which runs the unemployment insurance system, received a federal grant of €13 billion to cover the extra costs of German unification. In the 1990s, short-term consolidation of the social insurance budgets by means of federal subsidies was often financed by tax increases. At the end of 1997, an increase in the pension contribution rate was avoided by raising the value added tax from 15 to 16 per cent. In 1999, federal subsidisation of the pension

TABLE 2  
FEDERAL SUBSIDIES FOR PENSION AND UNEMPLOYMENT INSURANCE FUNDS, 1981–2003

Year	Federal subsidy to pension insurance fund		Federal expenditure on unemployment assistance ( <i>Arbeitslosenhilfe</i> )		Federal subsidy to unemployment insurance fund	
	In €m	In % of total revenue of pension insurance fund	In €m	As % of total expenditure of unemployment insurance fund*	In €m	In % of total expenditure of unemployment insurance fund
1981	13,933	17.75	1,457	10.1	4,197	29.1
1982	15,737	19.47	2,564	15.0	3,581	21.0
1983	15,888	19.76	3,642	17.6	806	4.8
1984	16,776	19.66	4,458	29.6	0	0.0
1985	17,155	19.03	4,666	30.7	0	0.0
1986	17,591	18.56	4,683	28.7	0	0.0
1987	18,203	18.79	4,617	25.1	0	0.0
1988	18,866	18.63	4,318	20.7	459	2.2
1989	19,532	18.38	4,195	20.6	987	4.8
1990	20,371	17.71	3,879	17.3	361	1.6
1991	25,808	18.51	3,648	9.9	524	1.4
1992	29,820	19.84	4,656	9.7	4,571	9.6
1993	31,978	20.58	7,145	12.8	12,485	22.3
1994	36,651	21.36	8,912	17.5	5,186	10.2
1995	37,470	20.90	10,486	21.1	3,522	7.1
1996	39,454	20.98	12,386	22.9	7,033	13.0
1997	42,229	21.41	14,315	27.3	4,895	9.3
1998	49,214	24.09	15,563	30.8	3,947	7.8
1999	49,822	23.52	15,581	30.1	3,739	7.2
2000	49,795	23.21	13,161	26.1	867	1.7
2001	53,342	24.21	12,778	24.3	1,900	3.6
2002	56,657	25.34	14,756	26.1	5,600	9.9
2003	61,173	26.38	16,532	31.1	6,200	11.7

\*Unemployment assistance is not included in the budget of the unemployment insurance fund.

Source: Pension insurance: VDR (Verband der Deutschen Rentenversicherungsträger), *Einnahmen der Rentenversicherung*, [http://www.vdr.de/internet/vdr/statzr.nsf/\(\\$URLRef\)/5F0E1B53C4AC2A6FC1256A390043F88D](http://www.vdr.de/internet/vdr/statzr.nsf/($URLRef)/5F0E1B53C4AC2A6FC1256A390043F88D) (22 Nov 2004); Bundesagentur für Arbeit: Bundesministerium für Gesundheit und Soziale Sicherung (BMGS), *Statistisches Taschenbuch, Arbeits- und Sozialstatistik* (Bonn, 2004), [http://www.bmgs.bund.de/download/statistiken/stat2004/Stb8\\_14.xls](http://www.bmgs.bund.de/download/statistiken/stat2004/Stb8_14.xls) (22 Nov 2004); Bundesagentur für Arbeit, *Haushaltsplan Haushaltsjahr 2004* (Nürnberg, 2004); Bundesagentur für Arbeit, Referat IIIc2 (Haushaltsreferat, Finanzauswertungen und Finanzplanung) Dipl.-Verwaltungswirt Dieter Spetzke.

fund was continued by the Red–Green government with the introduction of the eco-tax on energy and gasoline, whose fifth and last stage came into effect in 2004.

As a result of the decade-old practice of parafiscal burden-shifting and of balancing the social insurance funds by federal tax subsidies, the different social insurance budgets and the federal budget are now closely intertwined. Changes in contribution rates and benefit reductions in one of the social insurance schemes affect not only the other social insurance schemes but often the federal budget also. Lowering contributions in one branch of the social insurance system may require increases in another and is thus unlikely to have a discernible effect on total contributions. Put another way, structural reforms of only one of the four social insurance systems may merely exacerbate the crisis in the social insurance system as a whole.

The recession of 1992–93 changed the interaction between the budgets of the welfare state and the federal government, underlining that a social insurance system that had hitherto imposed no discernible cost to economic growth had become a burden. High non-wage labour costs had created a strong impediment to economic growth and a disincentive to private sector job creation, especially in labour-intensive service sectors. Additionally, European Stability Pact limits on state deficits had reduced the government's room for fiscal manoeuvre to subsidise the social insurance budgets. Rising non-wage labour costs and high unemployment also strained the loyalties of the constituencies of employer associations and trade unions.<sup>16</sup> By the mid-1990s, pressures for reform had grown enormously.

Reform, however, is not easy in the German political system. German unification increased the number of Länder to 16, with independently scheduled Länder elections turning national politics into an almost permanent election campaign.<sup>17</sup> During Schröder's first term there were 15 state elections, seven in 1999, two in 2000, four in 2001, and two in 2002. In addition there was the European election of 1999. In the first Land election after its accession to power (in Hesse in early 1999), the Red–Green government lost its majority in the Second Chamber, the Bundesrat. Since the February 2003 election in Lower Saxony, the opposition had held a solid Bundesrat majority that gives it veto power over all major legislation.

One way of lowering the costs of labour is moderation in collective wage bargaining. Here Germany has, on the whole, done surprisingly well.<sup>18</sup> In a Bismarckian welfare state, however, lower labour costs also require lower contributions to the three main sectors of the welfare state: pensions, unemployment insurance and labour market policy, reducing the financial burden imposed by the state on the employment relationship. Since coming to power in 1998, the Red–Green government has initiated a series of measures for welfare state reform in an effort to control public spending and increase employment. As we will show in the following sections, all of them have failed and indeed the entire political capital the government had available for welfare state reform had to be spent on keeping contributions at the level of 1998.

## PENSIONS

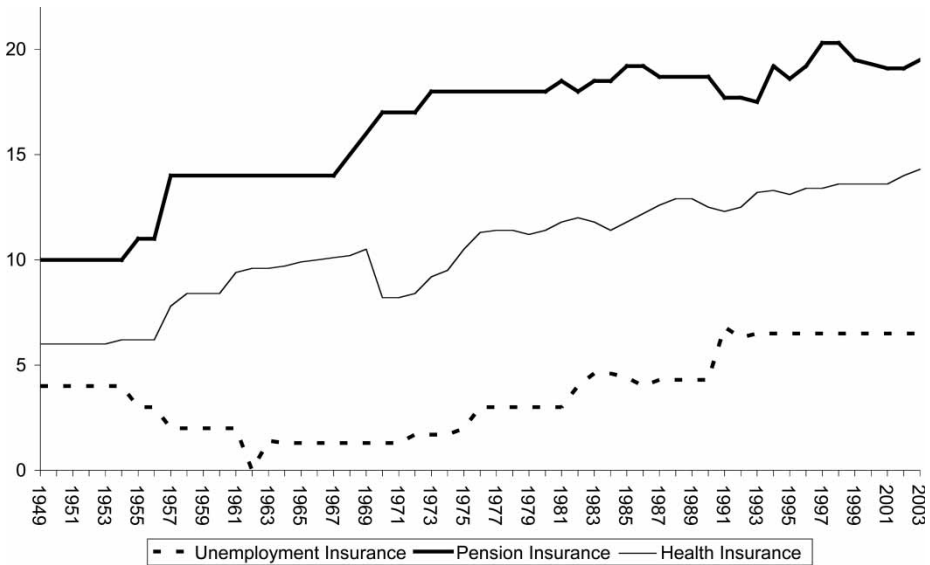
Until recently the basic principle of Germany's contribution-financed statutory pension system was maintaining the living standards of workers during retirement (*Lebenstandardsicherung*). Entitlements were calculated on the basis of the length of

their insurance record and the amount of contributions paid (calculated as a percentage of income, up to a cut-off point). In addition, the 1957 pension reform linked pensions to changes in the gross pay of active workers. The main aim of the government's pension policy was to adjust the revenues of the pension insurance funds to the expenditure required to serve the entitlements of those drawing pensions.

Since public pensions maintained living standards, the statutory pension system became the institutional core of the early retirement regime.<sup>19</sup> High public pensions allowed firms to restructure and close down plants without harsh conflicts with trade unions. Redundancies were chosen so as to make early retirement possible for older employees.<sup>20</sup> The manufacturing industry in particular soon learned how to make use of early exit options.<sup>21</sup> Early retirement policy allowed unions to adhere to their high-wage strategy because it absorbed surplus labour. It is not surprising that early retirement soon began to account for a growing part of the expenditure of the pension system. The result was both increasing statutory non-wage labour costs and higher government subsidies for pension funds, which were partially financed through higher taxes. Whereas in 1970 the federal budget accounted for 18.9 per cent of the total revenue of the pension insurance system, by 2000 this had risen to 23.2 per cent.<sup>22</sup>

In 1997, under pressure from rapidly increasing non-wage labour costs (Table 1; Figure 1), the Kohl government broke with the traditional consensus style of pension policy.<sup>23</sup> A reform aimed at stabilising the rate of insurance contribution introduced

FIGURE 1  
CONTRIBUTION RATES TO PENSION, HEALTH AND UNEMPLOYMENT INSURANCE,  
1949–2003



Source: See Table 1.

the principle of *einnahmeorientierte Ausgabenpolitik*, where benefits depend on revenues rather than vice versa, as previously.<sup>24</sup> Against the resistance of the opposition SPD a so-called 'demographic factor' was introduced, aimed at taking into account the increase in life expectancy. The demographic factor was to reduce the replacement rate of the 'standard pensioner' from 70 per cent in 1999 to 64 per cent in 2030. Moreover, disability pensions were cut by actuarial deductions.

The Kohl reforms contributed to the success of the Social Democrats in the 1998 Bundestag election.<sup>25</sup> During the campaign the SPD had promised to undo the cuts in benefits. Immediately after its accession to power, it delivered on its promise with the 1998 'Act to Correct Social Insurance and Guarantee the Rights of Employees' (*Gesetz zu Korrekturen in der Sozialversicherung und zur Sicherung der Arbeitnehmerrechte*). The law suspended the demographic factor and removed the cuts in disability pensions. The government also lowered the rate of contribution to pension insurance from 20.3 to 19.5 per cent, even though the suspension of the Kohl reforms was bound to cause higher expenditure. Schröder believed, however, that revenues could be increased by extending compulsory social insurance to certain categories of self-employed, which were declared to be pseudo-self-employed (*Scheinselbstständige*). In addition, in April 1999 the government introduced social insurance contributions for jobs in the low-wage sector, hoping that this would also generate revenues for the pension insurance scheme (*630-DM-Reform*). However, both reforms had the opposite effect as they added to the rigidity of the labour market and created new incentives to work in the underground economy.<sup>26</sup>

Suspension of the demographic factor was followed by numerous *ad hoc* measures aimed at stabilising the contribution rate without having to cut benefits. Most important among these were the ecological tax reform; a pension freeze in 2000–01, which tied pensions to consumer prices instead of wages; coverage out of the federal budget of a pension supplement for time spent child-rearing; and federal reimbursement of the pension funds for payments to specific groups of pensioners in the former GDR. The measures were accompanied by further reductions in the rate of contribution, from 19.5 to 19.3 per cent in 2000 and from 19.3 to 19.1 per cent in 2001. All in all, the government managed to lower the pension contribution rate between April 1999 and January 2001 by 1.2 percentage points. Taxation required to subsidise the pension system, however, took the estimated overall contribution rate of the average employee to around 28 per cent of gross wages.<sup>27</sup>

Having stretched the federal budget to its limit,<sup>28</sup> the measures of 1999 unintentionally forced the government to consider structural reforms that went beyond short-term fiscal remedies. It faced opposition, however, from trade unions like IG Metall that demanded a reduction in the statutory age of retirement to age 60 (*Rente mit 60*), which would have greatly accelerated the collapse of the social insurance system. Nevertheless, in June 1999 Labour Minister Walter Riester announced a major overhaul of the pension system to limit the contribution rate to a maximum of 22 per cent in 2030. At the core of his proposal was a mandatory private pension, which would have allowed the public pension to decline. This, in turn, would have held employer contributions constant, alleviating pressure on non-wage labour costs. The proposal was at loggerheads with social democratic plans to extend mandatory pension insurance to additional groups of employees and to other forms of income



than wage.<sup>29</sup> Unions, the opposition and the public violently objected to an obligatory private 'third pillar', and with the SPD suffering recurrent defeats in Länder elections, the government was forced to make concessions. Rather than making supplementary pensions obligatory, it adopted a more expensive strategy of liberal tax subsidies for workers choosing to buy supplementary pension plans. Nonetheless, polls showed that no more than 18 per cent of the voters regarded the SPD as the most credible party on pension policy.<sup>30</sup>

Against all expectation, the pension reform, enacted in 2001, became one of the more lasting achievements of Schröder's first term. The so-called *Riester-Rente* encouraged workers to take out private or occupational supplementary pension plans, helped by a government subsidy of up to €10 billion a year. Employees can now put a maximum of one per cent of their pay into a private savings account, rising to four per cent in 2008. Subsidies for these *Entgeltumwandlung* accounts, however, are conditional on the existence of a collective agreement signed by unions and employers (the so-called *Tarifvorrang*). The reform signalled a cautious move from a public pay-as-you-go system towards a privately funded system. In addition, a new formula for calculating pension benefits was introduced to reduce the pension level for the so-called 'standard pensioner' to 67 per cent of net income by 2030. Due to the high cost of government subsidies for private and occupational pension plans the reform will not really save money. It does, however, help keep non-wage labour costs in check.<sup>31</sup>

Still, pension reform and the energy tax failed to reduce overall non-wage labour costs during Schröder's first term. The most that was accomplished was a brief respite.<sup>32</sup> Shortly after its surprising re-election in 2002, the government had to recognise that the pension system needed yet more money. Its response was to plug the holes in social insurance budgets with a confusing mix of tax increases, spending cuts, higher contributions and new borrowing. On pensions, the most important measures of the so-called 'Act to Stabilise Contribution Rates' were an increase in the contribution rate by 0.4 percentage points to 19.5 per cent, which the Greens opposed; an increase in the income ceiling for contributions to the statutory pension system; and a reduction of the fluctuation reserve (*Schwankungsreserve*) of the statutory pension insurance system from 80 to 50 per cent of monthly expenditure (*Monatsausgabe*). To keep the contribution rate at 19.5 per cent, further emergency measures were put into effect, including another pension freeze in 2004 (*Nullrunde*), a further lowering of the minimum required fluctuation reserve from 50 to 20 per cent, and full contributions by pensioners to long-term care insurance from 2004 onwards. In addition, the disbursement of pensions was shifted from the beginning of the month to the end. As result, net pensions were effectively cut by 0.85 per cent in 2004.<sup>33</sup>

Whilst failing to bring about a lasting reduction of non-wage labour costs, the haphazard emergency surgeries performed on the pensions system since 1999 entailed major risks for the federal budget. In May 2003, the federal subsidy to the pension insurance system amounted to no less than €54 billion, and the Ministry of Finance forecast that by 2050 it would rise to more than half the federal budget if nothing were done.<sup>34</sup> By 2004 it was obvious that the limits of piecemeal tinkering had been reached and that more fundamental changes were required, although the direction these would take was far from clear. Ironically, the government seems to have returned

to its starting point. The 2004 law that adds a 'sustainability factor' to the pension formula to take into account the declining birth rate and the increasing life expectancy bore an uncanny resemblance to the Kohl government's 'demographic factor'. The measure had been suggested by a government-appointed expert commission in mid-2003. In addition, the commission proposed cutting pensions to 40 per cent of average gross earnings, from the present 48 per cent; a gradual increase in the statutory retirement age from 65 to 67 by 2035; and a capping of pension contributions at 22 per cent of gross monthly pay.<sup>35</sup>

#### THE LABOUR MARKET

Like the pension system, unemployment insurance played a crucial role in the traditional management of the German employment crisis.<sup>36</sup> The very expensive labour market programmes of what is now the Bundesagentur für Arbeit removed surplus labour from the market by providing unemployment benefit over long periods of time and extensive subsidies for short-term work, job creation and further training. In effect this created a huge secondary labour market at public expense. Next to the pension insurance system, the Bundesagentur für Arbeit (governed on a tripartite basis by the state and the social partners) became the focal institution for German social policy in the aftermath of unification. Labour market programmes expanded to unprecedented levels,<sup>37</sup> adding to non-wage labour costs and generating a spiral in which the very policy that was to fight unemployment became a potent contributor to it. In 2002 the Bundesagentur had a staff of 90,000 and a budget of €50 billion, around 40 per cent of which it spent on so-called 'active labour market policies'.<sup>38</sup>

Throughout its first term, the Red–Green government left labour market policy and the unemployment insurance system almost entirely untouched. The Chancellor delegated labour market reform to the tripartite talks of the Bündnis für Arbeit, which began in December 1998. Deadlocked almost from the beginning,<sup>39</sup> the Bündnis achieved nothing of significance apart from the so-called *Job Aqtiv-Gesetz* and two symbolic pilot projects to improve the labour market situation of low-skilled workers, the long-term unemployed and low-income families. *Job-Aqtiv* promised minor improvements in placement services for the unemployed. It also introduced what was sold to the public as the 'Danish job rotation model' and pretended to improve the control and evaluation of active labour market measures. At the same time, it extended publicly funded employment programmes. None of the measures produced any effect before they were overtaken by the so-called 'Hartz reforms' after the 2002 election.

In addition to the deadlocked Bündnis für Arbeit, another reason for inactivity on labour market policy in Schröder's first term was that Minister of Finance and party chairman Oskar Lafontaine insisted on following through election promises to the trade unions that made reform of the labour market practically impossible. For example, the government suspended a rule forcing firms to reimburse the unemployment insurance fund for benefits paid to workers sent into early retirement. Moreover, the government rescinded legislation obliging unemployed persons to show up at the job centre four times a year and to accept job offers that required them to commute for up to three hours a day. Further, employment protection was restored

for workers in firms with between five and ten employees, and low-paid part-time jobs were made subject to social insurance contributions. In addition, and in accordance with what he regarded as a 'Keynesian' economic policy, Lafontaine encouraged high wage claims from unions outside the public sector, thereby undercutting Schröder's attempts to use the tripartite talks of the Bündnis for wage moderation.

With the Red–Green government abstaining from labour market policy reform, the unemployment insurance system was just as starved of cash as the pension and health insurance systems. Soon after the 1998 election victory, the government had to implement measures to stabilise the unemployment insurance contribution rate and to limit its own payments to the Bundesagentur.<sup>40</sup> From June 2000 to July 2002, unemployment benefits were frozen in real terms, no longer rising with average wages as in the past. In addition, in 1999 the government abolished *Originäre Arbeitslosenhilfe*, a special form of unemployment assistance paid by the federal budget – a measure that the SPD had opposed under the Kohl government. At the same time, to limit youth unemployment the government passed the Emergency Programme to Reduce Youth Unemployment (*JUMP*) subsidising 100,000 jobs and apprenticeships for workers up to 25 years of age, which again imposed a burden on the federal budget.

A first step towards a reform of the public employment service was provoked by the so-called placement scandal at the Bundesagentur für Arbeit. In February 2002, when the government faced certain defeat in the upcoming federal election, it discovered what had long been widely known among insiders, that the statistics of the public employment service on its rate of success in job placement were largely fictional. To show the public that he was taking action 'to clean up the mess', Schröder created the 'Hartz Commission', named after its chairman, Peter Hartz, the personnel director at Volkswagen. The commission represented a break with the tripartite philosophy of the Bündnis für Arbeit<sup>41</sup> in that its 21 members included no more than two trade union representatives and only one official of a small-firm business association, the Federation of Craft Associations (*Zentralverband des Deutschen Handwerks*). The commission proposed a list of 13 reform measures, ranging from a weakening of the tripartite structure of the Bundesagentur to a rather vague appeal to the 'elites of the nation' to assist in creating employment opportunities for the unemployed. The commission's most important recommendations were to integrate unemployment assistance (*Arbeitslosenhilfe*) and social assistance (*Sozialhilfe*)<sup>42</sup> and to turn the job centres into temporary-employment agencies (*Personalserviceagenturen*). Anyone still jobless after six months was to be placed by the agencies in a private firm to perform temporary work. Hartz claimed that the commission's proposals could halve Germany's unemployment within three years and slash the costs of unemployment benefit by two-thirds.

After the 2002 election, two 'Acts Promoting Modern Labour Market Services' (commonly referred to as 'Hartz I' and 'Hartz II') were passed, tightening the rules determining which jobs an unemployed worker was allowed to reject (*Zumutbarkeit*), and the conditions for claiming unemployment assistance. In addition, workers facing unemployment were required to report earlier to the local employment service. Moreover, the reform raised the earnings limit for low-paid work exempt from social insurance contributions (*Mini-Jobs*) and introduced a scale of rising contribution rates for monthly incomes between €400 and €800. Also, various measures were passed to promote the employment of older people and the transition of jobless

workers to self-employment (the so-called *Ich AG*). Finally, the legislation provided for the creation of temporary employment agencies on the Hartz model.

In March 2003, shortly after the opposition had gained a solid majority in the Bundesrat by winning the Land election in Lower Saxony, Chancellor Schröder announced 'Agenda 2010' – a package of measures intended to make the German economy more 'flexible' and competitive. In addition to tax cuts and vague promises to make it easier for firms to opt out of sector-wide industrial agreements, the 'agenda' focused on pensions, health care and unemployment insurance. It included a reduction in Germany's generous unemployment and sickness benefits and proposed making it easier for small companies to hire and fire new workers. The measures that were ultimately introduced included a tax cut of €15 billion, a change in employment protection rules for companies with up to ten employees, and two more Acts to Promote Modern Labour Market Services (Hartz III and IV). To gain the agreement of the opposition, Schröder had to reduce the tax cuts which were intended above all to appease the public – something that CDU and CSU were not willing to let the government pay for by increased borrowing.

Agenda 2010 reinforced long-existing internal divisions between 'modernisers' and traditionalists among German trade unions. Germany's leading union, IG Metall, refuses as a matter of principle to take changes in non-wage labour costs into account when negotiating industry-wide wage increases. It was and still is bitterly opposed to Agenda 2010, running advertisements in national newspapers attacking the reforms as 'one-sided' and 'unfair'.<sup>43</sup> Its position is reflected in the DGB, whose chairman, Michael Sommer, labelled the reforms as 'dismantling the welfare state'.<sup>44</sup> On the other hand, the head of the chemical workers union IG BCE, Hubertus Schmoldt, urged unions to 'play an active role in a search for compromise',<sup>45</sup> proposing that the most controversial reforms should be tested in a pilot phase. Indeed IG BCE had already in 1999 concluded collective agreements that included private, supplementary pension plans and was eager to protect its approach. While the trade unions were debating, Germany reached the fourth-highest unemployment rate of all OECD countries, at 9.4 per cent, surpassed only by Poland, the Slovak Republic and Spain.<sup>46</sup>

Hartz III and IV relaxed employment protection for small firms and shortened the duration of unemployment benefit (*Arbeitslosengeld*) to 12 months (18 months for persons aged 55 or more), instead of 32 months in the past. The new rule, however, will not come into force until 2006.<sup>47</sup> The most far-reaching measure of the Hartz reforms was the amalgamation of unemployment assistance and social assistance into a single, flat-rate and means-tested benefit calculated according to principles of social assistance (*Arbeitslosengeld II*).<sup>48</sup> It also involved ending the dualism between labour exchanges on the one hand and social assistance offices on the other, for those receiving social assistance other than unemployment benefit. Both the amalgamation of unemployment assistance and social assistance and various measures for a further tightening of work availability requirements (*Zumutbarkeit*) were diluted in the legislative process. Nevertheless, on the day the Bundestag passed the bills, the Federal Minister of Economics and Labour, Wolfgang Clement, predicted that unemployment would drop by 20 per cent once the reforms were reality.<sup>49</sup>

The Hartz reforms were designed to lower the threshold of *Zumutbarkeit* for the unemployed, and in general to make labour market policy more 'activating' by

increasing incentives to work. Reform of the Bundesagentur für Arbeit, however, floundered in the face of resistance from SPD backbenchers, trade unions and employer organisations that fear for the funding of their extensive further education empires. It remains to be seen how much the Hartz measures will in fact lower expenditure for unemployment benefit and labour market policy, and with it the unemployment insurance contribution rate.

The same holds for whether the Hartz reforms will result in lower unemployment. According to the Council of Economic Experts (*Sachverständigenrat*), 'any attempt to forecast the volume of unemployment in 2005 is subject to major uncertainty',<sup>50</sup> not only because of low economic growth but also because Hartz IV will change the way unemployment is measured. It is even possible that the number of those registered as unemployed may rise by 300,000, especially in early 2005, due to the fact that Hartz IV includes former social assistance recipients in the statistics of the Bundesagentur. In November 2004, the research institute of the Bundesagentur announced that in 2005 unemployment may reach the politically devastating mark of five million.<sup>51</sup> Uncertainty about the development of unemployment makes the expected reduction in 2005 of the federal grant to the Bundesagentur from €6.2 to €4 billion unlikely. This being the case, a reduction of the unemployment contribution rate seems to be out of reach.

Nevertheless, Agenda 2010 has scared the electorate and made it even more volatile. It caused devastating defeats for the SPD in the state elections in Bavaria in September 2003 and in Hamburg in March 2004. To add to this, in January 2004 the supervisory board of the supposedly reformed Bundesagentur – composed of union, employer and public sector representatives – stated that it had 'lost confidence' in the agency's new chairman, Florian Gerster, an SPD politician appointed by Schröder in the aftermath of the 2002 scandal. While officially Gerster was blamed for minor irregularities over contracts for consultants, in fact he was punished for having tried to weaken the influence of the social partners. During all of 2004, the Bundesagentur remained in turmoil over its reorganisation. Beginning in 2005, it must pay the government a per capita lump sum of nearly €10,000 for each and every former recipient of unemployment benefit now reassigned to the new, tax-financed *Arbeitslosengeld II*<sup>52</sup> – at a total annual cost of €6.7 billion.<sup>53</sup> Apparent flaws in the new software designed for the disbursement of *Arbeitslosengeld I* and *II* caused additional costs in good will as well as in cash. In spite of having added thousands of employees to its staff of over 90,000 to cope with the reform, job placement by the Bundesagentur has come to a virtual standstill.<sup>54</sup>

#### HEALTH CARE

In the 1990s, the costs of the German health care system spiralled out of control. Between 1991 and 2002 spending on health care increased by 36 per cent.<sup>55</sup> The increase was attributable not only to the extension of the health care system to the new Länder but also to disproportionate growth in expenditure on pharmaceuticals and the introduction of long-term care insurance.<sup>56</sup> The rise in spending resulted in growing contribution rates. Between 1991 and 2002 contribution rates in the old and new Länder increased from 12.2 and 12.8 per cent to 14 per cent.<sup>57</sup> During the 1990s it was health insurance that contributed most to the rise in the overall contribution

rate to social insurance.<sup>58</sup> Currently health insurance contributions account on average for 14.3 per cent of gross wages, the second largest deduction after pensions.

A large part of the increase in health care expenditure is attributable to a lack of efficiency incentives and transparency and to over-capacities. The self-governing structure of the health care system allows doctors and pharmaceutical producers a great variety of strategies to circumvent government efforts to contain costs. Doctors enjoy considerable autonomy in writing bills for treatment and setting fees for their services. For example, pharmaceutical producers may respond to legal regulation forcing doctors to prescribe less expensive generic drugs by increasing the size of packages,<sup>59</sup> so as to defend their volume of sales.

Since health insurance funds may set contribution rates autonomously within the context of statutory provisions, the government has even fewer ways of bringing contribution rates in line with the goals of economic reform than is the case with pension and unemployment insurance. As it is the Länder which are primarily responsible for inpatient care, especially in hospitals, the capacities of the federal government are additionally limited by far-reaching legislative powers of the Bundesrat. Health care reform is further complicated by the fact that the Christian Democratic parliamentary party has always been deeply divided on the issue, particularly on health care finance. Whereas CDU leader Angela Merkel prefers funding health care by a flat rate to be paid by everybody (*Prämienmodell*), the labour wing of her party and the CSU favour the extension of the insurance-based system to additional groups of employees and forms of income.

That health care reform is especially difficult in Germany is due also to the self-governing character of the health care system and the effective organisation of the many interests involved in it, including big pharmaceutical companies, the doctors' lobby, the health insurance funds, and the hospitals. The KBV, the main doctors' association, is particularly effective in defending its clients. Its power derives from the fact that it functions as a statutory link between the doctors and the health insurance funds. Thus, the KBV collects the bills on behalf of the doctors and negotiates collective contracts with the funds. Because of the KBV system, the funds have practically no control over the treatment doctors provide. Health care funds are reduced to the role of 'passive financiers' rather than 'active purchasers of health services from suppliers on behalf of the patients'.<sup>60</sup>

As in pension and unemployment insurance, shortly after its election in 1998 the Red-Green government suspended some of the health care reforms of the Kohl government.<sup>61</sup> The 1998 'Act to Strengthen Solidarity in Health Insurance' rescinded cuts in the statutory reimbursement for dentistry and dropped co-insurance payments for drugs and other treatment-related costs. It also cancelled the automatic rise in co-payments with increases in contribution rates. At the same time, to stabilise the federal budget the government changed the calculation of the contributions paid by the unemployment insurance fund to the health insurance funds on unemployment insurance benefits, which resulted in lower revenues for the health insurance system.<sup>62</sup> The overall effect of the measures was to increase expenditures whilst simultaneously reducing revenues, making further reforms inevitable.

Measures for cost containment subsequently devised by Health Minister Andrea Fischer, however, were mostly abortive. Proposals for a global ceiling on spending

and the abolition of dual financing for hospitals were killed off by the opposition in the Bundesrat. All the government was able to obtain was a reform of hospital finance. Instead of a standard daily fee per patient, hospitals now receive a lump sum reflecting the type of treatment, regardless of the length of stay (*diagnose-orientierte Fallpauschalen*). Opposition in the Bundesrat was accompanied by a large-scale campaign involving all the major players in the health sector: doctors' associations, the pharmaceutical industry, and the health insurance funds,<sup>63</sup> not to mention the voters. Soon after, in early 2001, Fischer resigned, ostensibly over the BSE crisis.

The new minister, Ulla Schmidt (SPD), lifted the budget caps for prescribed drugs. Introduced in 1993, this measure had been under constant attack from doctors' associations. Schmidt replaced them with a system under which doctors' associations and health care funds set spending limits at the regional level. In effect, those responsible for the increase in expenditure were made responsible for controlling it. With no sanctions against non-compliance, however, the new arrangement for containing spending proved ineffective.<sup>64</sup> In 2002, self-regulation at the implementation level was further strengthened by the introduction of so-called Disease Management Programmes (DMPs) for chronic diseases. Under these programmes, an advisory board defines care standards that are then made obligatory by the federal government. With the exemption of some minor rule-changes, further reform measures were put on hold until after the election at the express instruction of the Chancellor.<sup>65</sup>

After the 2002 election had been won, the government could no longer avoid confronting the continuing crisis of health care finance. In the first of a series of emergency measures, the 'Act to Stabilise Contribution Rates' raised the upper income limit for the assessment of contributions to the statutory health insurance system to €5,100 per month and obliged health insurance funds to lower their contribution rates. Moreover, it imposed a zero per cent increase (*Nullrunde*) for the incomes of doctors and hospital workers. However, to relieve the federal budget by cutting the deficit in the unemployment insurance fund the same Act lowered the rate of health care contributions for persons drawing unemployment assistance, which reduced the revenue of health insurance funds. Although the Act made it illegal for funds to raise contribution rates, the Minister for Social Affairs of the Land of Bavaria encouraged the local health care funds to do exactly this.

The year 2003 became the year of health care reform. Scandals involving financial conspiracies between doctors, insurance funds and drug companies alerted the public to the vulnerability of the health insurance system to abuse and fraud. Among other things, doctors had used their professional autonomy to mislead health care funds about the costs of treatment, importing cheap products from abroad but charging full German prices. With the 'Act to Modernise the Statutory Health Insurance System' (*GKV-Modernisierungsgesetz*), the government sought to address inefficient practices in the health care system and prevent an expected increase in the contribution rate to up to 15 per cent in 2004.

The CDU/CSU having by then captured a solid majority in the Bundesrat, the final legislation could only be passed in agreement with the opposition. It introduced various measures to control expenditure (such as cancelling funeral benefit) and to strengthen competition among providers. Overall, however, it imposed most of the burden on patients rather than doctors or drug companies. Trade unions regarded the reform as

a historical departure from the principle of parity financing by workers and employers, and from the principle of solidarity. In part this reflected the fact that from 2006 onwards sickness benefit (*Krankengeld*) is to be financed solely by the insured. Equally controversial was the fact that the reform raised health insurance contributions on company pensions, which partially counteracted the government's objective of promoting company pensions as a supplement to declining public pensions. Taken as a whole, the Act sought to reduce the expenditure of the statutory health care funds by €20 billion, for example through higher supplementary co-payments, flat-rate charges for visits to doctors' offices, and the total exclusion of dentures from the list of standard services.

While cutting the health insurance contribution rate to 13.6 per cent in 2004, the Act also started a move towards subsidising health care through transfers from the federal budget. The new transfers, financed mainly through a three-stage increase in the tobacco tax, are supposed to cover various non-actuarial benefits (*versicherungsfremde Leistungen*). However, as demonstrated in pension insurance, such transfers can become self-perpetuating. In addition, once introduced, tax-financed transfers may constrain future fiscal policy.<sup>66</sup> With no explicit link to the extent of *versicherungsfremde Leistungen*, federal subsidies are likely to seep away in an inefficient system with an endless appetite for fresh cash.

Since the beginning of the 1990s, health care reform in Germany has mainly amounted to successive increases in co-payments by patients and in government support, which have hitherto failed to generate lower contribution rates. Government proposals to expand the funding base, on the model of the *Bürgerversicherung*, are being blocked by the CDU, reflecting the traditionally close relations between the party and the pharmaceutical industry and the associations of doctors and pharmacists.<sup>67</sup> In November 2004, after long and painful internal discussions, CDU and CSU presented a reform concept that tries to combine premium, contribution and tax-based forms of funding. It proposes a monthly premium of €109 to be paid by every insured person, supplemented by an additional €60 paid by employers – whose share would be limited to 6.5 per cent of gross wages – and by tax-financed subsidies to individuals with low income.

While there is deadlock on the financing side, cost-cutting on the supply side continues to meet with effective resistance from providers and the drug industry. Short-term emergency measures have reached their limit, and the view is gaining ground that nothing short of major restructuring will help. How such restructuring can be made to happen politically, however, is a mystery. Instead of a decline in contribution rates, the reform of 2003 will at best provide for stability over two or three years, although even this seems uncertain, as major health insurance funds have stated publicly that they see no possibility of cuts in contribution rates in 2005.

#### CONCLUSION AND PROSPECTS

In 1995 at the latest, with non-wage labour costs approaching the magic threshold of 40 per cent, cutting the economic burden imposed by the Bismarckian welfare state on the employment relationship in a changing economy and society became a central concern of German domestic politics, for the last Kohl cabinet as well as for



the two successive governments of the Red–Green coalition under Gerhard Schröder. However, after eight years of sometimes dramatic political conflict over welfare state reform, by 2003 non-wage labour costs, far from having come down, had risen further by two percentage points, with no end in sight (see Table 1).

If reforming the German welfare state continues to be as hopeless as it was for almost a decade, Germany's economic prospects are bound to deteriorate further. For some time, such deterioration may still proceed gradually and will therefore remain barely perceptible in the short-term view that dominates politics, public commentary and much of academic analysis. Weak employment will remain the core predicament of the German economy. While domestically traded services will stagnate, job losses in Germany's traditionally strong sector, high-quality manufacturing, will accelerate, not least due to the high German social insurance contributions. High spending on social welfare transfers will continue, to a large extent in compensation for low employment. Very likely, this will increasingly be accompanied by protest from those whose benefits must be cut in order to keep total expenditure constant or, more realistically, prevent it from rising by more than the small increments that can be presented to the public as conjunctural fluctuations.<sup>68</sup> And, given the tightening constraints on taxation of all sorts, the transfer-heavy welfare state, which at best mollifies the impact of low employment but cannot create employment itself, will continue to leave little if any space for public investment in the sort of infrastructure required to maintain the international competitiveness of a high-wage economy like Germany.

What prevents a fundamental restructuring – and nothing else would probably do – of a welfare state that is now widely recognised as strangling the labour market? At first glance it appears nothing short of astonishing that shifting the funding base of social insurance from contributions to general taxes should be politically difficult at all. Not only is there no reason in principle why such a shift should imply lower benefits, or why it should raise the total level of taxation including social insurance contributions. Also, a tax-based welfare state would be more redistributive and egalitarian than a contribution-based one, if only because contributions are usually paid only up to a specified income ceiling while income taxes, apart from a country like Slovakia, tend to be more or less progressive under democratic government.

A range of factors may be listed that have in the past decade stood in the way of meaningful welfare state reform in Germany, and will very likely continue to do so in the coming decade.

1. As has been shown, the pension and unemployment insurance funds are already heavily subsidised by the Federal Government, and subsidies have increased in recent years. Calls from the social policy community for tax support are not unknown to the Finance Minister, who from past experience tends to regard them as attempts to avoid cuts in benefits. Afraid of pouring fresh money into what invariably seemed to them a bottomless pit, all recent Finance Ministers have tried to make further subsidies conditional on structural reforms. The fact that they have rarely succeeded does not make them more amenable to proposals to shift the funding of the welfare state even further towards general taxes.
2. In any case, the first priority for the Federal Government is *balancing* its budget, not *expanding* it. The main criterion by which the performance of the Finance Minister

is judged year by year is whether his budget meets the targets of the Maastricht Stability Pact. These oblige him to reduce, not unemployment, but public borrowing. For some time now, German governments have in addition been under relentless pressure from business and the general public to lower corporate and individual taxes. Balancing the budget while cutting taxes leaves little space for refinancing social insurance.<sup>69</sup> This was experienced most dramatically by the CDU which, at its Leipzig party convention in late 2003, came out with great fanfare for both deep tax cuts and a complete de-coupling of public health insurance from wage and employment. The new system (a flat rate contribution called *Kopfpauschale*) implied that households with a low income were given tax subsidies. As was to be expected, the two projects turned out to be incompatible. Also unsurprisingly, the CDU later stuck to its tax cuts and abandoned the *Kopfpauschale*.

3. The trade unions, and in part also the employers, insist on separate parafiscal budgeting of social insurance, and on its being funded in principle by independent sources of revenue. Of course, unions in particular have no objections to social insurance being subsidised by the state, if this helps sustain or even expand benefits. An entirely tax-funded welfare state, however, is considered to be at the mercy of party politics and of government fiscal consolidation efforts, more than parafiscal institutions collecting contributions from workers and employers and operating under the 'self-government' of the 'social partners'. Employment concerns remain secondary as long as benefits for the non-employed can be defended, not least by pressuring the government to cover possible deficits in social insurance budgets. Employers, on their part, while certainly not averse to lower contributions, prefer lower taxes if they must choose, probably because a tax-based welfare state would be much more redistributive. Moreover, while German employers have become adroit at shifting employment to countries with lower labour costs, they may still have to pay income and corporate taxes in Germany. Finally, both union and employer associations cherish the many opportunities for patronage offered especially by the unemployment insurance system and the Bundesagentur für Arbeit that administers it.
4. The deadlock in German welfare state reform is not, however, exclusively caused by the undoubtedly impressive number of veto points and veto players in Germany's political system. The conservative welfare state and the *Äquivalenzprinzip* by which it is largely governed (the principle that benefits have to be basically proportionate to contributions, which in turn are proportionate to earned income) are popular with German voters, far into the middle class. The idea that status-securing social insurance entitlements are something like private property, rather than the outflow of a public right to social citizenship, is deeply rooted and is reinforced by German legal doctrine, which tends to impose narrow limits on political discretion with respect to earned entitlements. This corresponds to the fact that flat-rate benefits are widely considered incompatible with social justice.

In recent years, Germans have become wary of anything introduced to them as 'reform', which they probably rightly expect to end up in a reduction or levelling of their benefits. Resistance to change has assumed traits that an outside observer might easily be tempted to consider nothing short of irrational. In a representative

survey conducted in 2004, 50 per cent of the German adult population agreed that the social insurance systems faced 'significant problems' and another 44 per cent believed that they were 'about to collapse'. Still, 50 per cent stated that they were unwilling to retire later; 80 per cent did not find it necessary to lower the level of pensions; 68 per cent believed there was no need for employees to pay higher social insurance contributions; 69 per cent rejected the idea that health insurance funds might have to cut benefits; and no less than 80 per cent disagreed with increasing the legal age of retirement gradually to 67 years.<sup>70</sup>

Thus by the end of 2004, welfare state reform is taking more 'time out'. Faced with public protest against Hartz IV, the government concluded already in the middle of its term that voters had had enough of change for the time being. Now the strategy is essentially a return to the 'policy of a calm hand' (*Politik der ruhigen Hand*) of the summer of 2001, in the hope of some sort of spin-off from global economic recovery carrying the coalition over the September 2006 election. An important political side benefit of government inactivity is that it might tempt the opposition to make even more unpopular reforms a centrepiece of its election platform, predictably accompanied by two years of publicly displayed internal disagreement over how far such reforms may have to go. New serious attempts to break the stranglehold of the German welfare state on the German labour market will not be made until 2007 at the earliest, and are unlikely to come into force before 2008. In the meantime the governing parties hope that the continuing structural disintegration of the German social market economy can be covered up by a little fresh paint on its façade, like forcing the health insurance funds by law to put off repaying their debt and instead keep contribution rates constant or even lower them by a symbolic fraction. Once again it would appear that, according to an old German political adage, *Wahltag* will be *Zahltag*.

#### NOTES

1. See Herbert Kitschelt and Wolfgang Streeck, 'From Stability to Stagnation: Germany at the Beginning of the Twenty-First Century', in Herbert Kitschelt and Wolfgang Streeck (eds.), *Germany: Beyond the Stable State* (London: Frank Cass, 2004), pp.1–34.
2. *Ibid.*, Table 3, p.15.
3. See AmCham Germany and Boston Consulting Group, *AmCham Business Questionnaire 2003* (Berlin: AmCham Germany and Boston Consulting Group Deutschland, 2003), [http://www.dialogzukunft.de/de/data/pdf/amcham\\_wirtschaftsstandort\\_deutschland.pdf](http://www.dialogzukunft.de/de/data/pdf/amcham_wirtschaftsstandort_deutschland.pdf) (accessed 6 Dec. 2004); Sigurt Vitols, *Unternehmensführung und Arbeitsbeziehungen in deutschen Tochtergesellschaften großer ausländischer Unternehmen*. Studie des Forums Mitbestimmung im Auftrag der Bertelsmann Stiftung und der Hans-Böckler-Stiftung (Gütersloh: Bertelsmann Stiftung, 2001).
4. See Jörn Kleinert, Axel Schimmelpfennig, Klaus Schrader and Jürgen Stehn, *Globalisierung, Strukturwandel und Beschäftigung*, Kieler Studie 308 (Kiel: Mohr Siebeck, 2000), pp.71–7; for an overview of the effects of globalisation on the German economy and labour market, see Deutscher Bundestag, *Schlussbericht der Enquete-Kommission 'Globalisierung der Weltwirtschaft – Herausforderungen und Antworten'*, BT-Drks. 14/9200, <http://www.dip.bundestag.de/btd/14/092/1409200.pdf> (accessed 6 Dec. 2004).
5. Fritz W. Scharpf, 'Employment and the Welfare State: A Continental Dilemma', *MPIfG Working Paper 97/7* (Köln: MPI für Gesellschaftsforschung, 1997), pp.9–10; Fritz W. Scharpf and Vivien A. Schmidt, 'Conclusions', in Fritz W. Scharpf and Vivien A. Schmidt, *Welfare and Work in the Open Economy. Volume I. From Vulnerability to Competitiveness* (Oxford: Oxford University Press, 2000), pp.310–15.
6. Bernhard Ebbinghaus, 'Any Way Out of "Exit from Work"? Reversing the Entrenched Pathways of Early Retirement', in Fritz W. Scharpf and Vivien A. Schmidt (eds.), *Welfare and Work in the Open Economy. Volume II. Diverse Responses to Common Challenges* (Oxford: Oxford University Press,

- 2000), pp.511–53; Bernhard Ebbinghaus, *Reforming Early Retirement in Europe, Japan, and the USA* (Oxford: Oxford University Press, forthcoming in 2006).
7. Statistisches Bundesamt, *Durchschnittsalter der deutschen Studienanfänger und Absolventen nach Geschlecht 1980 bis 2000* (Wiesbaden, 2004), [http://www.destatis.de/download/hoch/bild12\\_1.xls](http://www.destatis.de/download/hoch/bild12_1.xls) (accessed 6 Dec. 2004).
  8. For a collection of comparative data on the German economy see Werner Eichhorst, Eric Thode and Frank Winter, *Benchmarking Deutschland 2004: Arbeitsmarkt und Beschäftigung*. Bericht der Bertelsmann Stiftung (Berlin etc.: Springer, 2004).
  9. See Wolfgang Strengmann-Kuhn, *Armut trotz Erwerbstätigkeit. Analysen und sozialpolitische Konsequenzen* (Frankfurt am Main: Campus, 2003).
  10. See Kitschelt and Streeck, 'From Stability to Stagnation', Table 1, p.11.
  11. Ibid. For a comparative overview of the development of employment rates, social expenditures and non-wage labour costs, see Table 4, p.15.
  12. Bernhard Ebbinghaus and Anke Hassel, 'Striking Deals: Concertation in the Reform of Continental European Welfare States', *Journal of European Public Policy* 7/1 (2000), p.46, Table 1.
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  14. Philip Manow and Eric Seils, 'Adjusting Badly. The German Welfare State, Structural Change, and the Open Economy', in Fritz W. Scharpf and Vivien A. Schmidt (eds.), *Welfare and Work in the Open Economy. Volume II. Diverse Responses to Common Challenges* (Oxford: Oxford University Press, 2000), p.265.
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  18. Anke Hassel, 'Negotiating Wage Restraint: Europe's Response to a New Economic Environment', Habilitationsschrift (Bochum: Sozialwissenschaftliche Fakultät der Ruhr-Universität Bochum, 2003), pp.216–18, <http://imperia.iu-bremen.de/hss/ahassel/36168/index.shtml>.
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  25. Schludi, *The Reform*, pp.143–144.
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28. Frank Bönker and Hellmut Wollmann, 'Stumbling towards Reform', in Peter Taylor-Gooby (ed.), *Welfare States under Pressure* (London: Sage, 2001), p.87.
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30. FORSA, 'Meinungen der Bürger zur Rentendiskussion', 1999 (unpublished).
31. Leibfried and Obinger, 'The State of the Welfare State', p.213.
32. Streeck and Hassel, 'The Crumbling Pillars of Social Partnership', p.118.
33. German Council of Economic Experts, *Consolidate Public Finances – Reform the Tax System. Annual Report 2003/2004*, First Chapter (2003), p.31.
34. *German News*, 28 May 2003.
35. See Bundesministerium für Gesundheit und Soziale Sicherung, *Nachhaltigkeit in der Finanzierung der sozialen Sicherungssysteme* (Bundesministerium für Gesundheit und Soziale Sicherung: Berlin, 2003), [http://www.arbeitnehmerkammer.de/sozialpolitik/doku/05\\_soziales/sgb\\_vi/berichte/2003\\_08\\_28\\_ruerup\\_lang.pdf](http://www.arbeitnehmerkammer.de/sozialpolitik/doku/05_soziales/sgb_vi/berichte/2003_08_28_ruerup_lang.pdf) (accessed 7 Dec. 2004).
36. Streeck, 'From State Weakness', pp.7–8.
37. Manow and Seils, 'Adjusting Badly', p.293.
38. Streeck, 'From State Weakness', p.8.
39. Wolfgang Streeck, 'No Longer the Century of Corporatism. Das Ende des "Bündnisses für Arbeit"', *MPIfG Working Paper 03/4, Mai 2003* (Köln: MPI für Gesellschaftsforschung, 2003).
40. By law, any deficit in the unemployment insurance fund must be automatically covered by the federal government.
41. Streeck and Hassel, 'The Crumbling Pillars', p.119.
42. In 2004, this was enacted by the so-called 'Hartz IV reform', which we will discuss later. Until the reform, German unemployment assistance consisted of 'unemployment benefit' (*Arbeitslosengeld*), financed by contributions from workers and employers, and the means-tested 'unemployment assistance' (*Arbeitslosenhilfe*), which was financed by the federal budget. Unemployed workers generally drew *Arbeitslosengeld* first and only moved to *Arbeitslosenhilfe* if they continued to be unemployed after their eligibility for *Arbeitslosengeld* had expired (the so-called long-term unemployed). *Arbeitslosengeld* was paid for a period of up to 32 months, whereas *Arbeitslosenhilfe* was offered for an unlimited period. Unemployed persons who were not eligible for *Arbeitslosengeld* or *Arbeitslosenhilfe* could apply for social assistance (*Sozialhilfe*). Whereas *Arbeitslosengeld* and *Arbeitslosenhilfe* were administered by the Bundesagentur für Arbeit, *Sozialhilfe* was administered by the municipalities (*Kommunen*) and mainly financed by them.
43. *Financial Times*, 23 May 2003, p.8.
44. *Ibid.*
45. *Ibid.*
46. Bertelsmann Stiftung, *International Reform Monitor. Social Policy, Labour Market Policy and Industrial Relations. Today's Survey, April 2004, Agenda 2010*, <http://www.reformmonitor.org> (accessed 18 April 2004), p.3.
47. This is because of a transition period of 25 months. The shorter period of entitlement will fully apply to all those claiming unemployment benefit from February 2006 onwards.
48. Unlike social assistance (*Sozialhilfe*), unemployment assistance (*Arbeitslosenhilfe*) was income-related. *Arbeitslosengeld II* is no longer tied to a recipient's former income, but will be set approximately at the (flat-rate) level of what used to be social assistance (€345 per month in West Germany and €311 per month in East Germany). *Arbeitslosengeld II* is financed out of the federal budget.
49. *German News*, 17 Oct. 2003.
50. German Council of Economic Advisers, *Annual Report 2004/05 'External Success – Internal Challenges'*, Press Release, 17 Nov. 2004, <http://www.sachverstaendigenrat-wirtschaft.de> (accessed 22 Nov. 2004), p.2.
51. *Frankfurter Allgemeine Zeitung*, 16 Nov. 2004, p.12.
52. *Ibid.*, 13 Nov. 2004, p.14.
53. *Ibid.*, 11 Nov. 2004, p.15.
54. *Ibid.*, 11 Nov. 2004, p.13.
55. *Financial Times*, 30 Jan. 2003, p.17.
56. OECD, *Economic Surveys Germany*, Vol.2002, Supplement No.4 – January 2003 (Paris, 2003), p.92.
57. *Ibid.*, p. 92.
58. *Ibid.*, p. 93.
59. *Deutsches Ärzteblatt* 101, 2 Feb. 2004, p.A-313.
60. OECD, *Economic Surveys*, p.96.
61. Leibfried and Obinger, 'The State of the Welfare State', p.212.
62. Unlike the other branches of the German social insurance system, the health insurance funds do not receive regular subsidies from the federal government. To cover a shortfall in their revenues, they are allowed within limits to incur debts.

63. Anja K. Hartmann, 'Patientennah, leistungsstark, finanzbewusst? Die Gesundheitspolitik der rot-grünen Bundesregierung', in Tobias Ostheim Christoph Egle and Reimut Zohlhnhöfer (eds.), *Das rot-grüne Projekt: Eine Bilanz der Regierung Schröder 1998–2002* (Wiesbaden: Westdeutscher Verlag, 2003), p.273.
64. OECD, *Economic Surveys*, p.93.
65. Hartmann, 'Patientennah', p.276.
66. German Council of Economic Experts, *Consolidate Public Finances*, p.30.
67. Bertelsmann Stiftung, *International Reform Monitor. Social Policy, Labour Market Policy and Industrial Relations. Today's Survey, April 2004, Comprehensive Health Care Reform*, <http://www.reformmonitor.org> (accessed 18 April 2004), p.3.
68. Upward pressure on contribution rates comes also from economic activity moving underground, depriving the social insurance system of revenue, and from the current rapid displacement of conventional employment by so-called 'mini jobs'. Mini jobs are low-wage jobs with significantly reduced social insurance contributions, introduced in the course of the Hartz reforms to facilitate employment especially in the service sector. They are an example of how a supposed solution to a problem can in fact aggravate it.
69. Thus taking effect at the beginning of 2004, the top income tax rate was once more lowered while co-insurance payments for low-income patients were raised.
70. Bundesverband Deutscher Banken, *Inter/esse: Informationen, Daten, Hintergründe* 11/2004, <http://www.bankenverband.de/pic/artikelpic/112004/IE112004.pdf> (accessed 13 Dec. 2004), pp.2, 6. Another example of how bizarre the German debate has become is the story of the CDU *Kopfpauschale*. The proposal was immediately attacked by the government as unfair as it would make 'the *Generaldirektor* and his secretary' pay the same monthly insurance premium. The attack was much in line with public sentiment, which almost immediately rejected the *Kopfpauschale* as 'neo-liberal'. This was regardless of the fact that the tax subsidy for low income earners that was part of the proposal would have significantly *increased* the effective contribution of high income earners – indeed to an extent that appeared outright shocking to the traditional CDU clientele, which at the time was rallying behind demands for tax relief. The *Kopfpauschale* was finally killed by the CSU, which managed to adopt the government position, according to which the proposal was 'unfair' to the *Generaldirektor's* secretary, while at the same time arguing that it was inconsistent with CDU and CSU remaining 'the parties of tax relief', including a significant lowering of the maximum rate of income tax.