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Economic Reform and the Political Economy of the German Welfare State

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Abstract

The key to economic reform in Germany is a significant reduction in the high costs of labour.The main factor driving up German labour costs is the funding of the extensive German welfare state through social insurance contributions that in effect operate like payroll taxes on employment. The paper discusses the political causes of the rise in non-wage labour costs since the 1970s. It then proceeds to show how a variety of opportunities for political blockade in the German political economy dim the prospect for effective reform in the foreseeable future.

Zusammenfassung

Die Wiederherstellung der Leistungsfähigkeit der deutschen Volkswirtschaft erfordert vor allem eine Reduzierung der hohen Arbeitskosten. Diese werden zu einem erheblichen Teil durch die Beitragsfinanzierung des Sozialstaats verursacht. Die Sozialbeiträge wirken wie Steuern auf Beschäftigung. Das Papier untersucht, warum die Lohnnebenkosten seit den siebziger Jahren so stark gestiegen sind, und zeigt, wie eine Vielfalt von politischen Blockademöglichkeiten effektive Reformen auf absehbare Zeit unwahrscheinlich macht.

Introduction

Contrary to a widespread view, the German economy does not suffer from a lack of international competitiveness.[1] In spite of the high euro, the German trade surplus rises regularly to new record heights, and the percentage of the population employed in exposed sectors, while declining as it is everywhere, continues to exceed the figures for any comparable country. In other words, if deindustrialisation in Germany is only proceeding slowly, this is not due to rigid labour markets, but to the still outstanding competitive performance of German industry. Wages in German industry are high, but they always have been and, until very recently, high German wages were by and large compensated for by high and fast-rising productivity. Thus, between 1990 and 1998, real unit labour costs in Germany declined by 6.8 per cent, which was faster than in almost all major competitor countries (Kitschelt/Streeck 2004: 15, Table 3).

Nor does the German economy face particular difficulties with respect to its internationalisation. Among the larger countries, Germany has always had by far the most internationalised economy, in terms of both export and import. Foreign investment in Germany continues to be substantial, notwithstanding employment protection, codetermination and a high wage level. Surveys of the executives of foreign firms indicate that, as in the past, the excellent German infrastructure, the high skills of the German workforce and the reliably peaceful labour relations on the German shop floor still represent a great attraction to firms intending to set up production facilities in Continental Europe (AmCham/Boston Consulting Group 2003; Vitols 2001).

German firms, for their part, have substantially expanded their activities in foreign countries, as they should in order to defend and increase their market share. That strong unions have interfered with this is a political myth. During the past decade, firms like Siemens, BASF, BMW or Volkswagen have evolved into true multinationals. The best-known example is, of course, Daimler-Benz, which turned itself into Daimler-Chrysler. (Nor should we overlook a firm like Hoechst, which merged into Aventis.) Even in the 1990s, the domestic employment effects of outward investment by German firms were, on balance, benevolent. While low-skilled jobs in Germany declined – something that would very likely have happened anyway as a consequence of foreign competition – high-skilled employment in research and development, sales, finance, etc. rose due to increasing production. Where things went well, and they often did, the result was an upgrading of the employment structure in Germany with only minor losses in the volume of employment (Kleinert et al. 2000: 71-77).[2]

Nevertheless, Germany does have a severe, and indeed worsening, employment problem, and it is in relation to this problem that the malfunctioning of German economic institutions, as well as the directions that economic reform would have to take, are best understood. Germany has for almost two decades now combined high unemployment with low participation in the labour market, resulting in a remarkably low rate of employment among citizens of employable age. Given that employment in industry is above the international average, the explanation is low employment growth in services, especially domestically traded services (Scharpf 1997: 9-10; Scharpf/Schmidt 2000: 310-15). While this has long been known, however, not much has been done about it, for a number of reasons. Above all, many of those outside employment have traditionally been taken care of by comparatively liberal unemployment and other social insurance benefits, or they have been offered early retirement on attractive terms (Ebbinghaus 2000, 2005). Others were kept out of the labour market by extended periods of education, resulting among other things in the fact that, by the late 1990s, German university students received their first degrees on average at age 29 (Statistisches Bundesamt 2004). Moreover, the rate of female labour market participation was traditionally low, turning the family into another holding pen for those unlikely to find employment in a stagnant or too slowly growing labour market.[3]

For a number of years now, however, it has become increasingly obvious that Germany 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 occupations and an aversion to 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 cuts in benefits that result make non-employment increasingly unacceptable to a growing number of people. This in turn not only causes political discontent but also sets in motion a transformation of the employment system from below, which for the first time in the post-war German economy involves the appearance of a sizeable number of 'working poor'.[4]

Seen against this background, the fact that economic growth in Germany is slow, even when measured on a per capita basis (Kitschelt/Streeck 2004: 11, Table 1), appears nothing short of dramatic. Since slow growth contributes to the crisis of public finance, its causes must be addressed, even though they may in part be demographic and therefore difficult to remedy in the short or medium term. Public revenues suffer from tax competition with countries in the European Union and beyond, and further from a desire on the part of citizens, at least as perceived by the politicians of all major parties, for ever new tax cuts. Moreover, tax reform in favour of corporations and individuals coincides with international obligations entered into at the inception of European Monetary Union to limit public deficits and bring down public debt, resulting in an apparently unending series of austerity budgets. At the same time, governments at national, Länder and local level are faced with firms, German and non-German, that have become more internationally mobile and insist on a well-developed infrastructure and on high levels of education as a condition for continuing to produce in Germany.

In addition, there are also indications that Germany may be beginning to lag behind other countries in high-technology sectors and in competition for emerging markets for highly innovative, high value-added products (Kitschelt/Streeck 2004: 15, Table 4). Whatever the reasons for this, addressing them would seem to require higher public investment in science and technology, which at a time of declining tax revenue could only come from cuts in social benefits of all sorts, if at all. It would also necessitate, among other things, reforms to the university system that would as a side effect make it less suitable as a refuge for surplus labour, not least since such reforms would have to end the post-war German principle of a free, i.e. government-funded, university education. Add to this the new low-cost competition from potential high-quality producers in Eastern Europe, including from plants owned by German firms themselves, which may for the first time make it impossible on a large scale for German production sites to compensate for their 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 remaining highly productive employment that in the past paid for the pacification of the non-employed may be about to break away at a much faster pace.

Where to begin with economic reform in an affluent country facing, and to some extent already experiencing, slow impoverishment? An often-cited suspect is Germany's vast and expensive welfare state. In specifying exactly how it relates to economic performance, however, it must be kept in mind that there are countries, such as Denmark or Sweden, which spend as much on social security as Germany – or even more – without having anything like a labour market crisis of German dimensions. Indeed, comparative research has produced convincing evidence that it is in particular the Bismarckian model of the welfare state, funded overwhelmingly through social security contributions and geared more to status maintenance than to protection from poverty, which depresses the level of employment by inflating the costs of labour. By the mid-1990s, statutory non-wage labour costs in Germany reached 40 per cent of the gross wage, which meant that a worker who wants a net income of 1,600 euro must have a gross income of 2,000 euro while costing his or her employer 2,400 euro, taxes not included. Especially in the period after unification, increases in non-wage labour costs often cancelled out the potentially benevolent effects of wage moderation on employment. Officially, however, Germany's leading trade 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, which in some years resulted in a twofold rise in labour costs, one by industrial agreement and the other through increases in social security contributions.

In the German system, high non-wage labour costs interact with unemployment in a vicious circle of positive feedback. 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, which among other things reduces the revenues of the social insurance funds, which in turn drives 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 by which unemployment used to be made socially acceptable become a cause of even more unemployment.[5]

The contribution of the German welfare state to the German economic crisis, and the need for welfare state reform as a centrepiece of economic reform, has not escaped the attention of politics and the public. Welfare state reform has been on the agenda since the mid-1990s, when the Kohl government committed itself not to let non-wage labour costs rise above 40 per cent in the short run and to reduce them significantly in the long run. Also, a 'structural reform of the social insurance system' was the top priority, at least on paper, of the ill-fated 'Alliance for Jobs' (*Bündnis für Arbeit*) set up by the first Schröder government after 1998 (Bündnis für Arbeit 1998). 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 former *Bundesanstalt für Arbeit,* now *Bundesagentur für Arbeit*, amounted to roughly 50 billion euro, which was spent on unemployment benefit, retraining (largely for non-existent jobs) and job creation (mostly in the East). At the same time, the combined budget of all German universities, including the polytechnics, was only about 27 billion euro (Streeck 2003a: 8). (In fact, roughly two million university students compared to more than four million unemployed by official statistics; the real number was closer to six million.) That German society manages to move significant resources from the satisfaction of mostly consumptive entitlements into investment in productive capacities has become the most fundamental condition for a successful defence of German prosperity. It is for this reason that, at least as far as Germany is concerned, economic reform today must, above all, be a reform of the welfare state.

In the next section we will briefly describe how it happened that German non-wage labour costs rose to a level where they now depress both the country's current employment and its future prosperity. We will then review the three most important sectors of the social insurance system: pensions, unemployment and health care. Tracing the reform efforts of the Red-Green government, we show why they fell far short of what would have been necessary to deal with Germany's endemic crisis of employment and investment. The final section will consider the political causes, both domestic and international, of the remarkable stickiness of the Bismarckian welfare state with its increasingly dysfunctional effects on the German economy.

The Rise of Non-Wage Labour Costs since 1970

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 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 (Manow/Seils 2000: 265). Social security supported the remarkably successful adjustment to declining mass production and 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, helping allay 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 rapidly transforming East Germany 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, later, 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 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 (Hinrichs 1998: 13; quoted in Ney 2001: 26).

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 parafiscal social insurance funds and the federal budget. Since the early 1980s, the government has tried with increasing skill to hide rising contribution rates and avoid cuts in spending 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 contributions to the pension insurance system for recipients of unemployment benefit, keeping 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 onwards, the unemployment insurance fund has had to pay pension insurance contributions for participants in job creation measures in East Germany (Table 2). While this increased the revenue of the pension insurance fund, in the long run it caused an 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.

Secondly, the government increasingly subsidised social insurance budgets to avoid raising contribution rates. The main measures in this context were federal grants to the pension and unemployment insurance funds (Table 3) and the coverage by federal transfers of benefits not calculated according to actuarial principles (*versicherungsfremde Leistungen*; Table 4). 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 euro; Table 3). In 1993, the *Bundesagentur für Arbeit*, which runs the unemployment insurance system, received a federal grant of 13 billion euro 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 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.

Since the recession of 1992 and 1993, the interaction between the budgets of the welfare state and the federal government has changed in a number of respects. The recession made it clear to the government that the social insurance system, which had worked well enough until then, at no discernible cost to economic growth, had become an economic 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. In addition, the European Stability Pact placed a limit on state deficits and thus 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 (Streeck/Hassel 2004: 107-13). By the mid-1990s, pressures for reform had grown enormously.

Reform, however, is not easy to achieve in the German political system. Because German unification increased the number of Länder to sixteen, the independently scheduled Länder elections turned German national politics into an almost permanent election campaign (Streeck 2003a: 13). During Schröder's first term there were fifteen state elections, seven in 1999 (Hesse, Bremen, Brandenburg, Saarland, Thuringia, Saxony, Berlin), two in 2000 (Schleswig-Holstein, North Rhine-Westphalia), four in 2001 (Baden-Württemberg, Rhineland-Palatinate, Hamburg, Berlin), and two in 2002 (Schleswig-Holstein, Mecklenburg-Western Pomerania). Added to this was the European election in the first half of 1999. In the first Land election after its accession to power (in the Land of 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 holds a solid Bundesrat majority.

Lowering the costs of labour requires wage moderation in collective bargaining. Here Germany has, on the whole, done surprisingly well (Hassel 2003: 216-18). 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 securing the living standards of workers during retirement (Lebenstandardsicherung). To insure that the standard of living was maintained, people were entitled to a pension 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. Following the principle of *Lebensstandardsicherung*, 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 which developed in the course of the employment crises after the two oil shocks and German unification (Trampusch 2005). 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 (Kohli et al. 1991: 190). The manufacturing industry in particular soon learned how to make use of early exit options (George 2000; Mares 2003). 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 (Trampusch 2003: Table 5).

In 1997, under the pressure of the rapid increase in non-wage labour costs since unification (Table 1; Figure 1), the Kohl government broke with the unions and the traditionally consensual style of pension policy (Schludi 2002: 150-51) and enacted a pension reform with significant cuts in benefits. Prioritising the aim of stabilising the rate of insurance contribution, the government shifted with this reform to *einnahmeorientierte Ausgabenpolitik*, where benefits depend on revenues rather than vice versa, as in earlier times (Leibfried/Obinger 2004: 200).[6] Against the resistance of the oppositional SPD a so-called ‘demographic factor’ was introduced, which was 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 (Schludi 2002: 153). 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 (Silvia 2002: 15).

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 and 2001, which was achieved by tying pensions to consumer prices instead of wages; coverage out of the federal budget of a pension supplement for time spent raising children; 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. Including, however, the taxes needed to subsidise the pension system, the estimated overall contribution rate of the average employee amounted to approximately 28 per cent of gross wages (Bertelsmann 2004a: 5).

As the ad hoc measures of 1999 had stretched the federal budget to its limit (Bönker/Wollmann 2001: 87), it became inevitable for the government to take pension reform more seriously. Since almost all non-actuarial benefits were already paid by federal subsidies, structural measures were called for that went beyond short-term remedies of fiscal crises. During Schröder's first term, however, trade union opposition to fundamental change in the pension system was still effective. In the course of the Alliance for Jobs, IG Metall, the biggest trade union, demanded that the government lower the statutory age of retirement to age 60 (*Rente mit 60*). This would among other things have undone the measures introduced under Kohl to increase the general retirement age. While the government was occupied devising a stream of emergency measures to contain exploding pension expenditures, Rente mit 60 would have caused the ultimate collapse of the social insurance system.

Despite resistance from trade unions and within the Social Democratic party, 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. He suggested introducing a mandatory private pension, for example, which would have allowed the public pension to decline, while holding employer contributions constant and thus alleviating the pressure on the non-wage costs of labour. The proposal was at loggerheads with social democratic proposals to extend mandatory pension insurance to additional groups of employees and to other forms of income than wage (Bönker/Wollmann 2001: 87). Unions, the opposition and the public violently objected to the private 'third pillar' being made obligatory. The protests together with recurrent defeats of the SPD in Länder elections, which were attributed to Riester's reform plan and to the switch to price indexation of pensions, forced the government to make concessions. Rather than making supplementary pensions obligatory, it adopted a more expensive strategy and offered liberal tax subsidies for workers choosing to buy supplementary pension plans. Nonetheless, an opinion survey conducted in September 1999 showed that no more than 18 per cent of the voters regarded the SPD as the most credible party on pension policy (FORSA 1999).

Against all expectation, the pension reform, enacted in 2001, became one of the more lasting projects of Schröder’s first term. It encouraged workers to take out either private or occupational, employer-based additional pension plans (labelled *Riester-Rente*), helped by a government subsidy of up to 10 billion euro a year. Since 2002, employees can put one per cent of their pay into a private savings account, and up to four per cent in 2008 (so called *Entgeltumwandlung*, payment commutation). Government subsidies for such accounts are, however, conditional on the existence of a collective agreement by which Entgeltumwandlung is regulated (the so-called *Tarifvorrang*). Responsible for this part of the reform was the union of chemical workers, IGBCE, which had already concluded collective agreements on pensions in 1999 and was eager to protect its approach. To this extent, Riester’s pension reform is the result of successful lobbying of the Ministries of Labour and Finance by a moderate trade union.

The 2001 pension reform has to a small extent moved the German pension system from a public pay-as-you-go system towards a privately funded system. In addition, by introducing a new formula to calculate pension benefits, the reform was intended to reduce the pension level for the so-called ‘standard pensioner’ to 67 per cent of his or her average net income in 2030.[7] However, due to the high subsidies for private and occupational pension plans introduced to make these palatable to the unions and the public, the reform will not really save money although it does help keep non-wage labour costs in check (Leibfried/Obinger 2004: 213). The new system is extremely bureaucratic, however, as private pension plans must satisfy a long list of criteria to be eligible for government subsidies.

In spite of the numerous measures enacted by the government to stabilise the pension system, overall non-wage labour costs did not fall during Schröder’s first term. In fact, all the pension reform and the energy tax accomplished was to keep them from rising, and only for a short period of time (Streeck/Hassel 2004: 118). In the autumn of 2002, just after its surprising re-election, the Red-Green government had to recognise that the pension system needed yet more money. It sought to plug the holes in the federal and social insurance budgets with a confusing mix of tax increases, spending cuts, higher contributions and new borrowing. With regard to 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 – although the Ministry for Social Affairs itself had expected it to rise to 19.8 per cent in January 2004 – 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 a result, net pensions were effectively cut by 0.85 per cent in 2004 (German Council of Economic Experts 2003: 31).

Notwithstanding the introduction of the private and the employer-based additional pillars in the pension system, on the whole the Red-Green pension reforms were no more than haphazard ad hoc measures. The series of emergency surgeries performed since 1999, while perceived as severe by voters, pensioners and trade unions, not only failed to bring about a significant reduction of non-wage labour costs; they also 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 euro, and the Ministry of Finance forecast that by 2050 it would rise to more than half the federal budget if nothing were done (German News, 28 May 2003).

By 2004, the limits of piecemeal tinkering were reached and more fundamental changes seemed to be inevitable, although the direction these would take was far from clear. Ironically, the Red-Green government seems to have returned to its starting point just as though it were playing monopoly on the back of the pension insurance system. In June 2004 the Bundestag enacted a law that adds a ‘sustainability factor’ to the pension formula to take into account the declining birth rate and the increasing life expectancy – the same measure the Kohl government had called the ‘demographic factor’. This measure was 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 (BMGS 2003).

The Labour Market

Like the pension system, unemployment insurance played a crucial role in the traditional management of the German employment crisis (Streeck 2003a: 7-8). 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 extensively subsidising 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*, which is 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 (Manow/Seils 2000: 293), 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 euro, around 40 per cent of which it spent on so-called ‘active labour market policies’ (Streeck 2003a: 8).

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. However, the *Bündnis* was deadlocked almost from the beginning (Streeck 2003b). 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, nothing of significance came to pass. *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 programs. 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 the government’s inactivity on labour market policy was the fact that, in the formative early period of Schröder’s first term, Oskar Lafontaine, who had run the campaign as party chairman, served as Minister of Finance. Lafontaine used his power to insist that several election promises to the trade unions were followed through on, which made reform of the labour market practically impossible. For example, backed by the traditionalists in the SPD, 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*.[8] For the period 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* (Streeck/Hassel 2004: 119) 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 thirteen 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*)[9] 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 Bundestag election in September 2002, two ‘Acts Promoting Modern Labour Market Services’ (commonly referred to as ‘Hartz I’ and ‘Hartz II’) passed Bundestag and Bundesrat. Under the legislation, the rules determining which jobs an unemployed worker was allowed to reject (*Zumutbarkeit*) were tightened, and so were 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 euro. Also, various measures were introduced 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. However, in February 2004 the German subsidiary of the Dutch firm Maatwerk, which operated 200 of the by now approximately 1,000 such agencies collapsed, leading to a public discussion about their viability.

After the opposition had gained a safe majority in the Bundesrat by winning the state election in Lower Saxony, Chancellor Schröder, in a speech to the Bundestag in March 2003, announced his ‘Agenda 2010’, a package of measures supposed 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 the three big pillars of the German welfare state, 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 finally passed included a tax cut of 15 billion euro, 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 with its solid majority in the Bundesrat, Schröder had to reduce the tax cuts which were mostly intended to appease the public. CDU and CSU would not allow the government to pay for this by increased borrowing.

Agenda 2010 reinforced long-existing internal divisions between ‘modernisers’ and traditionalists in the trade unions. Whereas the DGB chairman Michael Sommer labelled Agenda 2010 as ‘dismantling the welfare state’ (Financial Times, 23 May 2003: 8), the head of the chemical workers union, Hubertus Schmoldt, urged the unions to ‘play an active role in a search for compromise’ (Financial Times, 23 May 2003: 8). Schmoldt proposed that the most controversial reforms should be tested in a pilot phase. In contrast, IG Metall published advertisements in national newspapers attacking the agenda’s reforms as ‘one-sided’ and ‘unfair’ (Financial Times, 23 May 2003: 8). 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 (Bertelsmann 2004b: 3).

Hartz III and IV relaxed employment protection for small firms and shortened the duration of unemployment benefit (*Arbeitslosengeld*) to a general maximum of 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.[10] 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*).[11] 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 twenty per cent once the reforms were reality (German News, 17 Oct. 2003).

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* seems, however, to have failed so far, in part due to the resistance of unions and organised employers, who fear for the funding of their extensive further education empires. Another obstacle was backbench revolts in the SPD parliamentary party, which are potentially dangerous to the government as the Red-Green coalition has only a four-vote majority in the Bundestag. To what extent the Hartz measures will in fact lower expenditure for unemployment benefit and labour market policy, and with it the unemployment insurance contribution rate, remains to be seen.

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' (German Council of Economic Advisers 2004: 2), 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 5 million (Frankfurter Allgemeine Zeitung, 16 Nov. 2004: 12). 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 euro unlikely. This being the case, a reduction of the unemployment contribution rate seems to be out of reach.

However that may be, Agenda 2010 has scared the electorate and made it even more volatile. The reform package caused devastating defeats for the SPD in the state elections in Bavaria in September 2003 and in Hamburg in March 2004. Also, 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 chairman of the board, Florian Gerster, an SPD politician appointed by Schröder in the aftermath of the 2002 scandal. Officially, Gerster was blamed for several minor irregularities over contracts for consultants. In fact, however, his problem was that he had tried to weaken the influence of the social partners.

At the time of writing, the *Bundesagentur* is in turmoil over its reorganisation. From January 2005 onwards, it will have to pay a lump sum of nearly 10,000 euro to the federal government for every former recipient of unemployment benefit who, as a result of the Hartz measures, is reassigned to the new, tax-financed *Arbeitslosengeld II* (Frankfurter Allgemeine Zeitung, 13 Nov. 2004: 14). All in all, this so-called *Aussteuerungsbetrag* will amount to 6.7 billion euro in 2005 (Frankfurter Allgemeine Zeitung, 11 Nov. 2004: 15). The new software which is needed for the disbursement of *Arbeitslosengeld I* and *II* appears to be beset with flaws, which may mean additional costs for the *Bundesagentur*. Furthermore, it is expected that the agency may need to recruit more employees – in addition to its present number of over 90,000 – just to cope with the reform. At the same time, job placement by the *Bundesagentur* has almost come to a standstill (Frankfurter Allgemeine Zeitung, 11 Nov. 2004: 13).

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 (Financial Times, 30 Jan. 2003: 17). 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 (OECD 2003: 92). 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 (OECD 2003: 92). During the 1990s it was health insurance that contributed most to the rise in the overall contribution rate to social insurance (OECD 2003: 93). 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, (Deutsches Ärzteblatt 101, 2 Feb. 2004, p. A-313) so as to defend their volume of sales.

Since health care 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. This concerns particularly the reform of 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 financers’ rather than ‘active purchasers of health services from suppliers on behalf of the patients’ (OECD 2003: 96).

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 (Leibfried/Obinger 2004: 212). With the ‘Act to Strengthen Solidarity in Health Insurance’ of December 1998, it rescinded cuts in the statutory reimbursement for dentures 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.[12] All in all, the effect of the emergency measures of late 1998 was that expenditures increased while, simultaneously, revenues declined. Already in the subsequent year it was obvious that new reforms were inevitable.

In 1999 the Minister for Health Care, Andrea Fischer from the Green Party, proposed far-reaching measures for cost containment. Because the opposition killed most of them in the Bundesrat, the government made no headway on its two major proposals, the introduction of a global ceiling on spending and the abolition of the dual financing of hospitals. All the government was able to obtain was a reform of hospital finance. Instead of a standard fee per patient and day, hospitals now receive a lump sum reflecting the type of complaint treated, regardless of the length of a patient's stay (*diagnose-orientierte Fallpauschalen*). The less than constructive behaviour of the opposition in the Bundesrat was accompanied by a large-scale campaign of doctors' associations and the pharmaceutical industry against the reform. Ultimately Fischer's reforms were rejected by all major players in the health care sector: the doctors, the opposition, the Länder and the health insurance funds (Hartmann 2003: 273), not to mention the voters. Soon after, in January 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. As non-compliance by doctors with regional spending limits is not sanctioned, the new arrangement soon proved incapable of containing the spending increase (OECD 2003: 93). 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 minor changes to the rules governing risk adjustment among health care funds (*Risikostrukturausgleich*), no more health care reform measures were adopted for the rest of the government's first term. Chancellor Schroeder instructed the Minister not to seek any further changes until after the election (Hartmann 2003: 276).

In late 2002, after the election had been won, the government could no longer avoid paying attention to the continuing financial crisis of the health care system. The pre-election period had been spent with non-decisions on further cost containment measures, which reflected the traditionally good relations between the Christian Democratic parties and the pharmaceutical industry and the associations of doctors and pharmacists. In the autumn of 2002, however, rising health care contribution rates (which are set by the funds, not by the government) forced the government to enact a series of emergency measures. The so-called 'Act to Stabilise Contribution Rates' raised the upper income limit for the assessment of contributions to the statutory health insurance system to 5,100 euro 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, thereby reducing the revenue of health insurance funds. Although the Act made it illegal for funds to raise contribution rates, the Bavarian Minister for Social Affairs encouraged Bavarian health care funds to do exactly this.

2003 became the year of health care reform. Several scandals involving financial conspiracies between doctors, insurance funds and drug companies became public. The public became aware once more that its health insurance system was particularly vulnerable to abuse and fraud. Doctors used their professional autonomy to mislead health care funds about the costs of treatment. In collaboration with drug companies, doctors imported cheap products from abroad but charged full German prices to the funds. 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. Once more, however, pharmaceutical companies and their allies, the doctors and pharmacists, blocked several elements of the original reform proposal of the coalition (Bertelsmann 2004c: 3).

Given that the CDU/CSU by then had 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, the Act 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 euro, 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.

Also, the reform cut the health insurance contribution rate to 13.6 per cent in 2004, it started a move towards subsidising health care through transfers from the federal budget. The new transfers, which are in the main financed through a three-stage increase in the tobacco tax, are supposed to cover various non-actuarial benefits (*versicherungsfremde Leistungen*). However, as demonstrated by the example of pension insurance, such transfers can become self-perpetuating. In addition, once introduced, tax-financed transfers may constrain future fiscal policy (German Council of Economic Experts 2003: 30). As the federal contribution is not explicitly linked to the extent of *versicherungsfremde Leistungen*, chances are that it will seep away in an inefficient system with an endless appetite for copious amounts of 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. Until now, these have consistently failed to generate lower contribution rates. Expansion of the funding base, on the model of the '*Bürgerversicherung*', is blocked by the Christian Democrats, who in November 2004 – after long and painful internal discussions – presented a reform concept that tries to combine premium-, contribution- and tax-based forms of funding. It proposes a monthly premium of 109 euro to be paid by every insured person, supplemented by an additional 60 euro 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 seem to 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 in the short term, i.e. over two or, at most, three years. Already at the time of writing, however, even this seems uncertain, as major health insurance funds state publicly that they see no possibility of cuts in contribution rates in 2005.

Conclusion and Prospects

In 1995 at the latest, when non-wage labour costs approached the magic threshold of 40 per cent, cutting the economic burden the Bismarckian welfare state imposes 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 (Table 1).

If reforming the German welfare state, and especially the way it is funded, continues to be as hopeless as it was for almost a decade, Germany's economic prospects will remain poor, and chances are that they will further deteriorate in coming years. 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.[13] 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,[14] 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.

Why is it that almost a decade of attempted reform has not achieved anything apart, perhaps, from slowing down what would likely have been an even more dramatic increase of the statutory cost burden on labour in the German economy? What prevents a fundamental restructuring – and nothing short of this would probably do – of a welfare state that is now widely recognized as strangling the labour market? At first glance it would seem 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 a reduction in overall spending, or why it should raise the total level of taxation including social insurance contributions. In addition, it is almost assured that 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 seen, the pension and unemployment insurance funds are already heavily subsidized 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 necessary 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 base of the welfare state even further towards 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 publicly 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 precious little space for refinancing social insurance.[15] 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 (the *Kopfpauschale*) implied that households with a low income had to be given tax subsidies. As was to be expected, it turned out that the two projects were 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 in principle funded by independent sources of revenue. Of course, unions in particular have no objections to social insurance being subsidized by the state, if this helps in sustaining or even expanding benefits. An entirely tax-funded welfare state, however, is considered to be at the mercy of party politics and government fiscal consolidation efforts, more than parafiscal institutions collecting contributions from workers and employers under the 'self-government' of the 'social partners'. Employment concerns play less of a role as long as benefits for the non-employed can by and large be defended, not least by pressuring the government to cover possible deficits in social insurance budgets. While employers would not object to lower contributions, if they have to choose they seem to prefer lower taxes, probably because they are aware that a tax-based welfare state would be much more redistributive. Moreover, recently they have learned to shift employment to countries with lower labour costs, while they may still have to pay taxes in Germany on their personal income and that of their firms. Finally, both union and employer associations cherish the many opportunities for patronage offered especially by the unemployment insurance system and the huge agency that administers it, the *Bundesagentur für Arbeit* in Nürnberg.

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 immensely 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 extremely 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 that 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 their services; and no less that 80 per cent disagreed with the proposal to raise the legal age of retirement gradually to 67 years (Bundesverband Deutscher Banken 2004: 2,6).[16]

At the time of writing, by the end of 2004, the policy of welfare state reform is taking another time out. Faced with public protest against Hartz IV, the government has concluded already in the middle of its term that voters have 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 for some sort of spin-off from global economic recovery carrying the Red-Green 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 in 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 palliative measures that put 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*.

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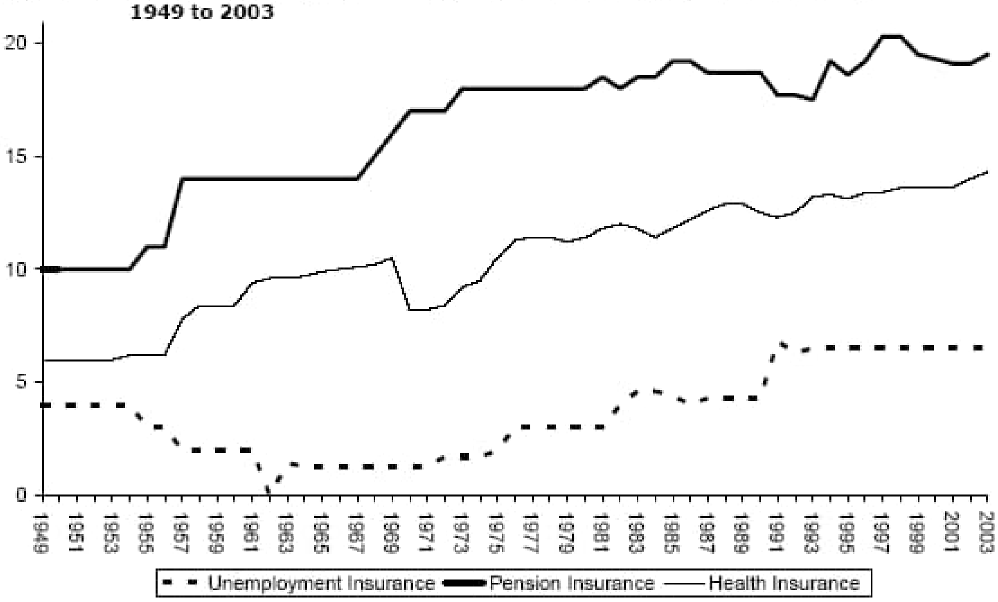
Figure and Tables

Figure 1 Contribution Rates to Pension, Health and Unemployment Insurance, 1949 to 2003



Source: Table 1.

Table 1 Contribution Rates between 1949 and 2003, as of the End of the Year

Year	Unem-ploy-ment	Pen-sion	Health Care	Total*	Year	Unem-ploy-ment	Pen-sion	Health Care	Total*
1949	4.0	10.0	6	20.0	1977	3.0	18	11.4	32.4
1950	4.0	10.0	6	20.0	1978	3.0	18	11.4	32.4
1951	4.0	10.0	6	20.0	1979	3.0	18	11.2	32.2
1952	4.0	10.0	6	20.0	1980	3.0	18	11.4	32.4
1953	4.0	10.0	6	20.0	1981	3.0	18.5	11.8	33.3
1954	4.0	10.0	6.2	20.2	1982	4.0	18	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	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	11.3	32.3					

Sources: 1949 to 2002: Trampusch (2003); for the data on health insurance in 2002 and 2003: BDA (2004).
* 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.

Table 2 The Social Insurance Shunting Yard (*Verschiebebahnhof*): Legislation on Financial Transfers between the Branches of Social Insurance between 1977 and 1992

Legislation	Change in Financial Transfer
Gesetz zur Dämpfung der Ausgabenentwicklung und zur Strukturverbesserung in der gesetzlichen Krankenversicherung 1977	Cut in transfer payments from pension insurance to health insurance
Gesetz zur 20. Rentenanpassung und zur Verbesserung der Finanzgrundlagen der gesetzlichen Rentenversicherung 1977	Unemployment insurance fund must pay contributions to the pension insurance fund for recipients of unemployment benefits and other unemployment insurance cash benefits
21. Gesetz über die Anpassung der Renten aus der gesetzlichen Rentenversicherung 1978	Unemployment insurance fund must pay contributions to the pension insurance fund for recipients of disability pensions
Gesetz zur Konsolidierung der Arbeitsförderung 1981	Cut in contributions for unemployed persons paid by unemployment insurance to health insurance funds
2. Haushaltsstrukturgesetz 1981	Increased contribution rate to unemployment insurance offset by decreased contribution rate to pension insurance (contribution bargain)
Haushaltsbegleitgesetz 1983	Reduced transfer payments for pensioners from pension insurance to health insurance
Haushaltsbegleitgesetz 1983	Reduced transfer payments for the unemployed from unemployment insurance to pension insurance
Haushaltsbegleitgesetz 1983	Increased contribution rate to unemployment insurance offset by decreased contribution rate to pension insurance (contribution bargain)
Haushaltsbegleitgesetz 1984	Health insurance funds must pay contributions to pension and unemployment insurance for recipients of sickness pay
Gesetz zur Änderung von Vorschriften des Arbeitsförderungsgesetzes und der gesetzlichen Rentenversicherung 1984	Increased contribution rate to pension insurance offset by decreased contribution rate to unemployment insurance (contribution bargain)
Gesetz zur Stärkung der Finanzgrundlagen in der gesetzlichen Rentenversicherung 1985	Ditto
Siebentes Gesetz zur Änderung des Arbeitsförderungsgesetzes 1985	Ditto
Gesetz zur Reform der gesetzlichen Rentenversicherung 1989	Reduced transfer payments for the unemployed from unemployment insurance to health insurance
Gesetz zur Reform der gesetzlichen Rentenversicherung 1989	Increase in the contributions paid by health insurance funds to pension and unemployment insurance for recipients of sickness pay
Gesetz zur Reform der gesetzlichen Rentenversicherung 1989	Increased transfer payments from unemployment insurance to pension insurance
Gesetz zur Änderung der Beitragssätze in der gesetzlichen Rentenversicherung und bei der Bundesagentur für Arbeit 1991	Increased contribution rate to unemployment insurance offset by decreased contribution rate to pension insurance (contribution bargain)
Gesetz zur Änderung von Förderungsvoraussetzungen im AFG und in anderen Gesetzen 1992	Unemployment insurance must pay contributions to health insurance for participants in job creation measures in East Germany (§249 AFG)

Source: Trampusch (2003).

Table 3 Federal Subsidies for Pension and Unemployment Insurance Funds, 1981 to 2003

	Federal subsidy to pension insurance fund		Federal expenditure on unemployment assistance (*Arbeitslosenhilfe*)		Federal subsidy to unemployment insurance fund	
	In million euro	In per cent of total revenue of pension insurance fund	In million euro	As a percentage of total expenditure of unemployment insurance fund*	In million euro	In per cent 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

Sources: Pension insurance: VDR (2004); Bundesagentur für Arbeit: BMGS (2004); Bundesagentur für Arbeit (2004); Bundesagentur für Arbeit, Referat IIIc2 (Haushaltsreferat, Finanzauswertungen und Finanzplanung) Diplom-Verwaltungswirt Dieter Spetzke.

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

Table 4 Federal Subsidies to Pension and Health Insurance Funds

Legislation	Federal Subsidy
Gesetz zur Stärkung der Finanzgrundlagen in der gesetzlichen Rentenversicherung 1985	Extraordinary federal grant to pension insurance funds
Gesetz vom 25.9.1990 zu dem Vertrag über die Schaffung einer Währungs-, Wirtschafts- und Sozialunion zwischen der Bundesrepublik Deutschland und der Deutschen Demokratischen Republik 1990	Extraordinary federal grant to pension insurance funds
Gesetz zur Finanzierung eines zusätzlichen Bundeszuschusses zur Gesetzlichen Rentenversicherung 1997	Extraordinary federal grant to pension insurance funds, financed through an increase in the value added tax from 15 to 16 per cent
Gesetz zum Einstieg in die ökologische Steuer- und Abgabenreform 1999	Extraordinary federal grant to pension insurance funds, financed through an ecological tax (five-stage increase in the ecological tax between 1999 and 2004)
Gesetz zur Korrekturen in der Sozialversicherung und zur Sicherung der Arbeitnehmerrechte 1998	Federal funding of higher pension insurance benefits for periods spent raising children (*versicherungsfremde Leistungen*)
Gesetz zur Korrekturen in der Sozialversicherung und zur Sicherung der Arbeitnehmerrechte 1998	Federal funding of benefits for groups of pensioners in the new Länder (*versicherungsfremde Leistungen*)
GKV-Modernisierungsgesetz 2003	Extraordinary federal grant to the health insurance system financed by the a three-stage increase in the tobacco tax

Source: Trampusch (2003).

Endnotes

1
For a general assessment of the competitive position of the German economy, see Kitschelt/Streeck (2004).

2
For an overview of the effects of globalisation on the German economy and labour market, see Deutscher Bundestag (2004).

3
An excellent collection of comparative data on the German economy is Eichhorst et al. (2004).

4
For a detailed empirical analysis of the 'working poor' in Germany, see Strengmann/Kuhn (2003); for a comparative overview of the incidence of working poor in the EU countries, see Eurofound (2004). The study points out that, in 1999, among the Continental welfare states Germany had the second highest proportion of unemployed poor (after Luxembourg; Eurofound 2004: 15 and 17, Figure 2). In addition, it reveals that in 1996 the percentage of working poor who were continually in employment was, at 70 per cent, much higher in Germany than in other European countries (Eurofound 2004: 20-21).

5
For a comparative overview of the development of employment rates, social expenditures and non-wage labour costs, see Ebbinghaus/Hassel (2000: 46, Table 1).

6
The first step towards stabilising contribution rates to pension insurance was the Pension Reform Act of 1989, which raised the legal age of retirement and linked pensions adjustments to net rather than gross pay.

7
This holds for the current pension formula. Using the previous formula, the reduction would presumably have been even larger, to around 64 per cent of the average net wage.

8
Under the law, any deficit in the unemployment insurance fund must be automatically covered by the federal government.

9
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.

10
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.

11
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 euro per month in West Germany and 311 euro per month in East Germany). *Arbeitslosengeld II* is financed out of the federal budget.

12
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 their debts.

13
Upward pressure on contribution rates comes also from economic activity moving underground, depriving the social insurance system of revenue, as well as 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 solution to a problem can at the same time aggravate it.

14
Unlike the Scandinavian welfare state, which is primarily a provider of social services.

15
Thus at the beginning of 2004, the top income tax rate once more declined while at the same time co-insurance payments for low-income patients under the public health insurance scheme were raised.

16
Another demonstration of how bizarre the German debate has become is offered by 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 earners of high incomes compared to the present system – 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 pointing out 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.

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