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FOCUS GERMANY

The new German Government and its Central Political Challenges

Marc Brost

More than 15 years after reunification, Germany is again a divided country. I am not referring to the differences between east and west, not the "wall" in people's heads which is still there after all that time. What I refer to is the economic situation in Germany: the question as to how well or badly off Germans are.

We have all read the headlines about *"Germany's surprising economy"*, we have all read - especially in the foreign media - that Germany's chances of an economic revival are now greater than they have been for some time. Conversely, we are all aware of the opinion of most German commentators: reforms so far have not been far-reaching enough; the Germans must learn to tighten their belts; or, as the German Federal President Horst Köhler put it in his TV appearance when the German parliament was dissolved: *"The nation's finances are in a dire state hitherto unknown. Our future and that of our children is at stake."*

Voters had the choice of two models

As befits a country so divided, Germans were faced during the recent election with two utterly different concepts.
On the one hand, there was the Nordic model, along the lines of Denmark, Sweden or Finland. The Nordic model means a high level of state spending and strong trade unions, comparatively high wages and relatively low employment severance protection but with strong support for the unemployed in the first few months. That was more or less the SPD's election manifesto.
The CDU/CSU alliance was presenting the Anglo-Saxon model - and not just because Angela Merkel was constantly compared to Maggie Thatcher. The Anglo-Saxon model means weaker trade unions and a largely unregulated labour market, companies empowered to act - and ultimately the implicit promise of far greater economic growth than in the rest of the continent of Europe.

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Neither the SPD nor the CDU/CSU will be able to implement their ideas in full; the voters have forced the large parties into a grand coalition, which at first glance appears to comprise disparate elements and has an enormous task ahead of it. Precisely because it now became so difficult to imagine adhering so closely to either of the two “role models”, the future German government might be able to succeed in taking a different path: the German one.

Germany as a Business Location: better than its reputation

In mid-October leading German economic research institutes published their autumn appraisals: economic recovery is progressing slowly; the German economy continues to be influenced by trends from outside the country; private expenditure is still weak; the situation in the labour market is not good. All this can be backed up by hard facts - and yet it is only part of the reality of the German market.

The truth is that at the economic grass-roots, at the shop-floor level in factories and companies, momentous changes have been occurring. The majority of German companies are in better shape than was the case a few years ago. Real wage costs per unit are back at the level of 1995. Domestic employees are increasingly willing to accept changes and limitations in their terms of employment in order to keep their jobs. Everywhere in Germany, in hundreds of companies, collective wage agreements have long since been watered down and the constant call for a more open approach to employment contracts is long since a reality. Of course, the trade unions are happy that there is as good as no public discussion of this. After all, who is ready and willing to depart from traditional positions? It is however also in the interests of the employers for the reform of employment conditions to be implemented without too much fuss. The unions and workers' councils would find the whole affair too humiliating otherwise - and that would lead to conflict instead of consensus.

The new reality does have an important psychological component however. Job loss is not an unavoidable fate for employees. There is a chance in any company to fight for jobs by using simple means - like working hours accounts, flexible working hours, individual salary negotiations. That sort of action sends an important signal to employers: Just you look, jobs can be saved, even in Germany. And new ones can be created too.

According to a study by the World Bank, in 2004 conditions for companies in Germany improved more than in any other industrialised country. Salaries have been decreasing in real terms over the past five years, a fact which has made many companies more competitive. That is only too clear from profit reports: German companies' profits rose in the first six months of 2005 by 22%. Since the beginning of the year, foreign investors have invested more than 150 billion euro in Germany. They are all backing the idea of a German economic revival. And basically, the chances of that are not bad at all: companies are at last investing again, if somewhat cautiously. In real terms, investment in hardware, like computers and machines, rose by 7.5% in the second quarter of the year, representing the strongest increase since the end of 2000.

This is the classical model of export-fuelled growth, which has applied many times in Germany in the past: companies repatriate part of their profits generated abroad and invest the proceeds in Germany. That raises employment. That means that job prospects improve and people's incomes increase. And the consequence of that is that consumers open their wallets and purses and flock to the shops.

Such a scenario is based on two decisive factors. First, the investors really must mean business over a sustained period of time. And secondly, the initially cautious expansion has to generate a reaction in the domestic market - and that is precisely where all the previous revival attempts have come unstuck in the last years. If the model is to succeed this time round, then the policies of the grand coalition need to be watertight in some crucial policy areas.

a) Social Security Systems

The aim of the social security system is basically twofold: the system needs to be so solid that even the children of today's contributors can depend on it. And it is important not to burden the employers and employees alike with economy-related fluctuations in contribution levels. In other words: what is needed is a tax-driven foundation to the system.

During the recent election campaign, the conservative alliance parties spoke in favour of health insurance flat-rate bonus irrespective of income, while the SPD declared a preference for a so-called citizen's insurance, a health insurance scheme for everyone. What will they eventually agree on? Whatever the outcome, it will be achieved in small steps, but those steps are important: the grand coalition will put a freeze at least on the employer contribution, which will keep additional wage costs down. It will continue to cut health insurance expenditure and encourage people to sign up to private insurance, which will promote competition between health insurers. These are small steps, it is true, but they are leading in the right direction.

In any case, the crucial point when it comes to the social system lies elsewhere: the future of state-funded retirement pensions. Payments to pensioners have been cut by almost one third since 1992. There is no scope for more cuts - and any more would not be realistic in view of the ageing population. Something else has to give, and there is a strong argument that a grand coalition, made up of a cross-section from the political parties, can take the risk of at last making Germans work longer hours again. Both of the large parties, the conservative alliance and the SPD, refused throughout the election campaign to talk about raising from 65 to 67 the age at which employees are entitled to a state pension. Yet both parties know that an ageing population cannot avoid using the knowledge and skills of its older citizens in new ways. From an economic viewpoint, the Germans are going to have to work much longer, till they are 70 according to present-day professors of economics, and ultimately society might well decide to abolish a statutory retirement age altogether.

This is something which has not been implemented anywhere else in Europe so far. It would be the first step of a German model.

b) The labour market

Originally, the CDU/CSU wanted to weaken severance protection considerably, to open up wage agreements and to increase the value-added tax rate in order to reduce contributions to unemployment benefit. The SPD on the other hand was keen to establish a minimum wage above all.

A grand coalition will probably agree to widen the scope for unemployed people to earn money in addition to their benefits, by finally creating a combined earnings model already implemented in a number of other countries. The new government will also create the legal framework for a minimum wage, if nothing else to placate the trade unions. And it will - in a controversial move - reduce the period of entitlement to unemployment benefit from 18 to 12 months, while simultaneously banding the benefits according to the number of years of contributions paid in.

The new government's biggest problem however is one which beset the previous government: Hartz IV, the name given to the reforms implemented by Gerhard Schröder's government relating to welfare and unemployment benefits and the job allocation system.

The costs of these reforms have spiralled out of control. Instead of the predicted 14.6 billion euro, the federal government is going to have to find at least 26 billion euro for the long-term unemployed this year. On top of these costs there is also a sum of 12 billion euro which local government will have to find. Hartz IV is basically nothing more than a cipher for the biggest miscalculation of public expenditure ever known. Ten months after the reforms' implementation, the real work - of encouraging the long-term unemployed to apply for jobs and get back to work - has not even begun in earnest. Similarly, ten months after the reforms becoming law, the job consultants are working with unfinished software, and many staff members at the job agencies will confirm off the record that they are spending up to 60% of their time correcting the software errors by hand. That leaves very little time for the real work.

At the heart of it all, there remains the basic dilemma, however: no matter how sensible a scheme it may be, Hartz IV alone cannot create new jobs. For that, the economy needs to experience growth. Which brings us to the most important area of policy: fiscal policy.

c) Fiscal policy

Originally, the conservatives wanted to reduce income tax, increase value-added tax and radically cut all tax breaks. The SPD was in favour of a "tax for the rich", an additional tax on people earning very high salaries, and an increase in inheritance tax for private households. There will have to be a compromise. The idea of radical tax reforms is off the agenda, but one thing is already clear: at least business tax will be reduced to 19%, as agreed at the "job summit" meeting held in spring 2005. Capital gains tax for sales of equity stakes will be reintroduced, but companies can survive that. The old “Germany plc” of cross-over share-holding has in any case been dissolved.

Peer Steinbrück, the designated SPD Finance Minister, will find his books in Berlin in a desolate state. More than 65 billion euro are missing for 2006 alone. The plan is to fill that gap with record income from privatisation (32 billion euro) and new loans (21.5 billion euro). But what happens in 2007? By then, the federal assets will to a great extent have been cannibalised. At the same time, both the conservative alliance and the SPD are asserting that by 2007 at the latest the federal republic of Germany will be adhering to the rules of the EU Stability Pact. 35 billions euro of budget savings are planned for until 2007 to stabilise the public finances.

It would be the largest package of public spending cuts in the entire history of the German Federal Republic. It could also turn out to be the biggest economic error. By applying a policy like this, the future finance minister is operating not like an economist, but like an ordinary treasurer. Or, to put it another way, the grand coalition would implement a procyclical policy which could sweep away all efforts towards reform. Already today Germany finds itself in a stagnation trap. There is a vicious circle of low state expenditure, low economic growth and stagnation-generated state debt.

The possible social consequences of such action are laid out in the autumn reports of the German economic researchers. Not only do the experts expect private consumption in 2005 to decrease in real terms by 0.5%, they also expect that in 2006 real wages will - as in all previous years - increase more slowly than formal standard wages. That means that most Germans - wage-earning employees - will still not have money to spend on consumer goods. This is a dangerous social phenomenon because it means that the inequality in the country increases. "The income of self-employed people and asset-generated income," on the other hand, according to the economic experts, "will ... yet again increase at an exponential rate," because entrepreneurs and shareholders benefit from the improved overall conditions and higher corporate profits.

Stagnant or decreasing income among wage-earning employees, combined with increasing income among self-employed people and the wealthy in a stagnating economy, is an explosive mix in social terms which can only be defused by economic growth.

The new finance minister should ask himself therefore: how can I increase growth? I believe the answer is clear: an intelligent combination of tax and economic policy is what is needed. There is a necessity to simplify the tax system in order to lessen the burden on the man in the street, and to reduce corporation tax in order to attract investment. At the same time, it is necessary to increase inheritance tax. In a society where inheritance is commonplace, inheritances become income, but inheritance can also intensify inequity in society if only a section of the population inherits something, especially when that "something" turns out to be substantial in wealth terms. An increase in value-added tax would of course also be necessary, especially in order to reduce additional wage costs. But why not reduce additional wage costs first and only increase value-added tax later, say a year later? A staggered approach is already under discussion among economists. However, Berlin looks set to increase value-added tax WITHOUT reducing additional wage costs. The costs of labour will such rise again.

If only 500,000 unemployed people were to re-enter the employment market, then the public purse would be relieved of a burden amounting to about 11 billion euro a year, according to experts. On that basis, the burning issue of the day is therefore what policy the future grand coalition partners should give priority to: Implement spending cuts in order to put the national accounts in order? Or prioritise growth in order to reduce unemployment in the short term, and so rebalance the national financial situation via long-term improvement in tax revenues?

There is an example of how not to proceed: Japan. In 1997 there was evidence of an economic upswing there, and the government immediately increased the rate of value-added tax. The mood changed and the economy slumped back into recession - for a further seven years.

In the USA, on the other hand, the government has three times in the recent decades spent an enormous amount of money in order to avoid recession - in 1982, 1990 and 2001. Denmark implemented sweeping tax reforms in 1993 coupled with a classical investment programme.

Government spending in the UK and Finland at the beginning of the 1990s pushed the fiscal deficit up to almost 8% - but economic growth between 1993 and 2004 was more than double that of Germany. As a result of this economic boom the British and Finns were able to turn their deficits into healthy surpluses.

The "German Way"

All very well, one may say, that's simply pragmatic economic policy. But where is the "German way" in all of this? The answer lies in Europe. A long-term programme of stabilising the state finances can of course only function as a result of coordination within the European Monetary Union, especially in a country like Germany, which this year will for the fifth year in succession fail to adhere to the European Stability Pact's deficit rule. In the German model, then, a new German government would not only prove that structural reforms and an anticyclical fiscal policy do not need to be a contradiction in terms. It would also become the engine for European reforms: it would champion a sensible change in the stability pact and better coordination of national economic policies.

This almost sounds like historical irony: it was the SPD that was capable of engineering the hardest social reforms in the history of the Federal Republic of Germany, even though the party almost broke apart as a result. Only the SPD could push through these reforms against the will of the trade unions - its own clientele. Surprisingly, now a CDU/CSU-led grand coalition might just yet succeed in achieving the dual goal of combining growth policy with structural reforms - even if debt would initially rise as a result. Thanks to the "economic competence" attributed to the conservative parties, they could fire up economic growth in the short term, push through structural reforms in the medium term and finally sort out the budget and financial situation in the long term. Only the conservative parties would be able to carry through such policies against the resistance of their own clientele: the hitherto dominant "stability cartel" comprising the federal bank, the conservative press and conservative professors.

Following the federal election in 2002 Germany was in a very similar economic situation to now. The "red-green" coalition of SPD and Greens then abolished numerous tax breaks, cutting back social benefits and increasing contributions to health insurance and unemployment benefits. That meant that in a stroke, an employee with an annual income of 65,000 euro had 1000 euro less in his pockets. Germans tightened their belts, stopped spending, and sales of consumer goods plummeted. Three years of continued stagnation followed. Only the number of jobless increased. And despite all the efforts at cutting costs, the national debt increased.

Back then, the head of the conservative CSU, Angela Merkel, warned that by implementing the wrong policies Germany could spiral into a trough of depression and deflation; she was severe in her criticism of the red-green tax cuts.

Three years later, as the chancellor-elect of a grand coalition, she now has the opportunity to do many things better. Or even better, to get it all right.

Translation: Janet & Michael Berridge