

# The Effect of Germany's Social Market Economy on Competitiveness

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## Introduction

The German social market economy, with its generous social benefits and corresponding high tax rates, is at a crossroads. As the world moves from the Industrial Age to the Information Age, flexibility and agility are the keys to success. The Information Age is characterized by a high risk, entrepreneurial environment, where businesses must continually transform to compete in a dynamic market. The German economic model is characterized by low risk investment by banks and an inflexible, centralized labor market.

Lawrence and Schultz argue that Europe's slow growth of recent times is a result of the changed structure of growth. During the 1950s and 1960s, growth in Europe and, especially, Germany exceeded historical experience. This was the result of special circumstances, including an abundant supply of workers and the influx of advanced U.S. technology. (Lawrence and Schultz, p. 3) The supply of workers increased with the transition from agriculture to industry and from immigrants from neighboring countries in the east and south. The European countries were essentially in a technological catch-up mode, where imports in U.S. technology led to rapid increases in productivity.

During the 1970s, this situation began to change. Lawrence and Schultz document five factors that changed the structure of growth. First, labor relations deteriorated with the increase in labor militancy across the continent. Second, the first oil shock in 1973 interrupted the cheap energy source Europe was used to and hence increased costs. Third, exchange rates became adjustable, which had the effect of increasing European labor costs toward parity with those of its competitors. Fourth, European countries could not rely on catching up with the U.S.; they were now on the frontier of technology and had to lead. Competitiveness on the frontier of technology depends on innovation rather than the adoption of existing technology. Flexibility and risk taking are crucial to technological innovation. During this time, Europe focused on medium-technology products and fared poorly in information industries and other high-tech sectors. Fifth, labor must be able to move within companies and across sectors of the economy. This reallocation of labor and other factors of production is crucial to the success of new technology. In Germany and other European countries, limits on the firing of workers and rigid union contracts limited the reallocation of labor and the growth prospects of new technologies. The U.S., according to Lawrence and Schultz, successfully reallocated its labor force essentially through a reliance on the free market. (Lawrence and Schultz, p. 4)

Lawrence and Schultz also place part of the blame for Europe's poor economic performance on the excessive role of the state. Relatively minor regulatory objectives like safety on the job were expanded to ensure worker participation in the decisions of management and government oversight of plant

closure and layoffs. As Lawrence and Schultz note: "Failing firms are bailed out by subsidies, nationalization and trade protection. Failing workers are bailed out by employment subsidies, extensive unemployment and disability benefits and training programs." (Lawrence and Schultz, p. 7) Companies are reluctant to hire full-time workers because of the limits on firing them and are reluctant to hire part-time workers because of distortions from social insurance costs.

The slowdown in growth in the 1970s occurred not only in Europe, but also in the U.S. and Japan. Post-war growth was consistently higher in Europe than in the U.S., while unemployment was consistently lower in Europe. But since 1980, growth in the U.S. and Japan has been almost double that of Europe, while unemployment has been significantly lower in the U.S. and Japan. The main concern in Europe over competitiveness is in the high-tech sector. Both the U.S. and Japan have much higher shares of world exports of high-tech goods than they do for goods as a whole, while Europe (and particularly Germany) still relies on traditional industries (medium technology) such as the automotive and chemical industries. Few European firms are competitive in the microelectronics sector, while the U.S. dominates the microprocessor sector, and Japan and other Pacific Rim countries dominate the memory chip sector. The U.S. also dominates the computer software sector. Europe's biggest effort to challenge the high-tech dominance of the U.S. has been Airbus Industrie, a consortium of European aerospace companies. Despite heavy governmental subsidies of Airbus, however, the U.S. retains its dominant share of the world aerospace market. (Krugman, p. 57)

## **Eurosclerosis**

"Eurosclerosis" has been the term (coined by Herbert Giersch) used to describe the abysmal performance of most of the Western European economies in recent times. (Caldwell, p. G4) Caldwell describes the "symptoms" as "big government, onerous taxes, high labor costs, ... an overly generous welfare state, ... and double-digit unemployment." (p. G4) There is no doubt Germany falls into this category. Government spending in Germany is approximately 50 percent of GDP, compared to 33 percent in the U.S. This forces Germany to have the highest tax burden among major industrialized countries. Labor costs in Germany are also the highest in the world. One out of every three marks spent by the German government is spent on social programs. The unemployment rate in Germany now exceeds 11 percent (February, 1996). As a result of these factors, Germany and the rest of Western Europe had practically no net gain in private sector employment during the 1980s compared to the 19 million net new jobs in the United States during the same period. Assar Lindbeck, a Professor of International Economics at the University of Sweden, attributes the better performance of the American economy to "the ability not only to absorb an increasing labor force but also to recover from recessions and to shift resources - labor as well as capital - to expanding industries." (Lindbeck, p. 158) The German Research Minister, Paul Krueger, says, "People are no longer prepared to bear risks in Germany. They didn't have to for a long time because there has been really great prosperity. We're talking about a society that is sated." (Benjamin, p. A1)

According to Lindbeck, it is the "long-term gradual deterioration in the functioning of some basic mechanisms" of the West European economies that is to blame for their weak performance. This has been caused by two factors. First, there is the inability of both real and relative wage rates to equilibrate various parts of the labor market and to adjust to new circumstances. The second factor is the increased costs and inflexibilities in the labor markets due to higher (and highly-distorting) taxes and the increased regulation of employment. (Lindbeck, p. 155) Taxes increased as a result of the rapid increase in public spending combined with the attempted redistribution of income. And when abrupt changes in relative costs, like the oil shocks in the 1970s, and international competition required rapid reallocation of resources, the rigidities started to become a severe disadvantage to the West European countries.

The high unemployment rates in Germany are compounded by the fact that a large proportion of German jobless are considered long-term unemployed. OECD (Organization for Economic Cooperation and Development) numbers show that of all of Germany's unemployed, one out of three have been out of work for at least a year compared to only one out of ten in the United States. (Schlaes, "A Germany That Kills Science," p. A22) In the U.S. unemployment "rotates" among a larger fraction of the labor force than in Europe. This rotating unemployment affects more people and keeps down the rate of increase in nominal wages because more people are aware of the risks of unemployment. (Lindbeck, p. 158)

There have been four main theories that have been suggested to explain the long-term unemployment problem in Germany and the rest of western Europe: a Keynesian demand gap, a neoclassical wage gap, a hysteretic labor market, and structural rigidities. (Giersch, p. 196) The Keynesian demand gap theory states that a lack of aggregate demand is the main explanation for West German unemployment. This lack of demand is the result of contractionary policy shifts: a strong anti-inflationary monetary policy and a deficit-reduction fiscal policy. This theory, however, fails to provide reasons for the fact that even in times of strong economic growth, long-term unemployment persists in most of western Europe. The neo-classical wage gap theory suggests that until labor costs have been too high for full employment to be reached. Giersch, however, argue that the neoclassical wage gap is not the cause of the increase in unemployment, but may be detrimental to attempts to decrease unemployment. The hysteretic labor market theory was first presented in the 1980s to explain the long-term unemployment problem in Europe. It suggests that after long recessions, a dual labor market develops with two kinds of workers: those who remain unemployed and those who are jobless for only a short time. The long-term unemployed have trouble re-entering the workforce due to a lack of work experience, a lack of motivation, or demoralization. Finally, Giersch, Paque and Schmieding argue that structural rigidities are the primary reason for the long-term unemployment problem. These rigidities can't explain sudden increases in unemployment, which they attribute to cyclical forces, but can help explain the phenomenon of long-term unemployment. Some of these rigidities are high labor costs, high taxes, large social costs, a regulatory burden, and an inflexible workforce. (Giersch, pp. 202-203)

## **Structural Rigidities**

### **Labor Costs and Rigidities**

One of the structural rigidities of the German economy concerns the German labor market. The German worker's wages are among the highest in the world today. This is part of the reason why unit labor costs are 40 percent higher in Germany than in the United States and Japan. These high costs are forcing some of Germany's "bread and butter" industries to move production and investment elsewhere. For example, the German Auto Industry Federation has predicted that one-third of German car production will be shifted abroad by the year 2000. (Gallagher) There are other factors besides costs that come into play, but nevertheless this is a troubling trend for one of the staples of German industry. The German chemical industry, another of Germany's core industries, is also following this trend. The chairman of Bayer, Manfred Schneider, has said that more production will be exported to the dynamic Pacific Rim market and to the United States. (Gallagher)

Once heralded for the labor peace it insured, Germany's centralized bargaining system now appears too rigid. Under this system unions negotiate on an industry level instead of with individual companies. The unions also elect workers' councils where they have a say in management decisions, including dismissals. This system has been very successful over the years. During the 1960s and 1970s when wages in the United States were skyrocketing, wage increases in Germany were much closer to productivity increases, thus keeping inflation down. Now, with larger companies dominating the

industry groups, some small companies see the system as a major problem. Because the main incentive for larger companies is to insure labor peace and keep their operations from shutting down, they have not been taking the hard line with the unions that the smaller companies want. Smaller companies don't have the ability to absorb these large labor cost increases, and the centralized system doesn't make any provisions for them. This is leading many of the smaller companies to challenge the status quo by quitting the industry groups and negotiating on their own.

The centralized bargaining system has also led to a compression of pay differentials across sectors and among differently skilled workers. These compressed pay differentials don't reflect productivity differences. If there is not a large difference between the income of a highly skilled worker (such as a doctor) and a low skilled worker (such as a machinist), the incentives to obtain advanced skills will be diminished. Also, an increase in the wages of low skilled laborers leads to a decrease in employment for these same workers. This leads in turn to an inflexible labor market where wages are not greatly affected by changes in demand for and supply of labor.

One cause of high labor costs is the strength of German unions. They have been able to increase their pay, while at the same time decreasing their workweek. The recent agreement between the IG Metall Union and Gesamt Metall Employers Association (March 7, 1995) is a prime example. Even with the unemployment rate near 10 percent in Germany, the union was still able to wring a generous two-year deal from the employers. The union received a 4 percent rise in nominal wages in the first year of the deal and no increase in the second. The workweek for these workers was cut to 35 hours from 36 hours. This cut in hours leads to high overtime costs in times of increased demand. This labor agreement does not appear to be overly generous, but the chief economist at Goldman, Sachs & Co. in Frankfurt, Thomas Mayer, predicted wage costs would increase at more than twice the rate of inflation as a result of the deal, (Templeman, p. 60) This settlement also led to similar settlements in other sectors, including chemicals and insurance, and is a bad omen for German industry.

The argument for labor flexibility in this era of rapid technological advancement rests on the need for resources to be allocated to industries of strong potential growth and away from declining industries. The German collective bargaining system, along with governmental restrictions on the firing of labor, restricts the normal allocational mechanisms of the labor market, leading employers to be reluctant to hire more labor. There are two types of restrictions on labor mobility: restrictions on labor turnover such as employment protection laws, and distortions of the wage structure (e.g., compression of pay differentials) so that relative wages no longer provide an accurate signal of where labor resources are valued most. (Flanagan, p. 188) In Europe, legislation and collective bargaining long ago dismissed the possibility that a worker could be let go at the will of the employer. In Germany, employers must show that adjustment methods that would avoid layoffs (e.g., short-time work and retraining) have been attempted before dismissals can be approved. Lack of profitability is not, in itself, a sufficient justification; authorities must be convinced that dismissals are a last resort. (Flanagan, p. 194)

## **High Taxes**

Taxes in Germany currently amount to 44 percent of GDP compared to 31 percent in the United States. The troubling fact is that recent trends in Germany have led to higher and higher taxes. Since reunification there have been implemented a special reunification tax, an energy tax, an insurance tax, an automobile tax, a tobacco tax, a second insurance tax, an increase in the value-added tax, a tax on interest, a third insurance tax, a second energy tax, and a second tax on personal vehicles. These taxes were all initiated with the allegedly "conservative" Helmut Kohl administration in power. The effect of these tax increases is an increase in the cost of doing business in Germany and a decrease in the competitiveness of Germany internationally.

The top income tax rate, for those who make \$80,000 or more, is already above 50 percent. These high personal tax rates have led the famous German tennis superstar, Boris Becker, to abandon his native country in search of tax relief in Monaco. Steffi Graf, another famous tennis star, has recently been under investigation for tax evasion. Another result of these high rates is the decreased incentive to take risks and start new businesses. The lesson learned in the United States during the 1980s was that a decrease in the marginal tax rates led to exceptional growth. This was a result of the increased incentives to take risks and invest capital with the knowledge that individuals would be able to keep more of what they earned.

The corporate tax rate in Germany is the highest of any OECD country, with a 58.95 percent rate at the top of the scale. (Bartlett, p. A18) This is another burden on Germany's businesses and probably forces them to lower their levels of employment.

## **Social Costs**

There are three main types of obligatory social security programs in Germany: a pension plan, health insurance, and unemployment insurance. The contributions for the three programs are split evenly between employers and employees. According to the Confederation of German Employers' Association, social contributions paid by the employer (on top of wage costs) were 84 percent of direct wage costs in 1993, compared to 77 percent in 1987 and 50 percent in 1970. In 1993, German direct wages ranked fifth highest in the world, but when social costs were figured in, Germany topped the list in labor costs. (Confederation of German Employers' Association, p. 3) With the steady aging of the German population and the shrinking of the working population, the social security system is in need of serious reform. The problem is similar to that of the United States and the "Baby Boomers." The addition of 17 million new claims from the former East Germany, without a large increase in contributions, has made the situation even worse. The social security contribution rates have risen from 26.5 percent of gross income in 1970 to 39.1 percent in 1994. (Peel, p. XI)

Germany has two separate unemployment programs: Arbeitslosengeld and Arbeitslosenhilfe. Arbeitslosengeld is unemployment insurance for experienced unemployed workers. It is not subject to a means test and is financed through a payroll tax on both employers and workers. A worker is eligible for insurance if he or she has satisfied contribution requirements. The duration of benefits received by the worker is linked to the duration of contributions from the worker. Arbeitslosenhilfe is unemployment assistance mainly for those who have exhausted their insurance. It is means tested and financed out of general revenues. The assistance is determined as a percentage of a worker's wages minus income tax and social security contributions. The assistance requirements are more lenient than those of unemployment insurance despite being means tested. There is no time limit for such assistance. (Burtless, pp. 127-28)

Burtless documents four main effects of generous unemployment benefits on unemployment. First, the benefit can lengthen the average duration of unemployment by reducing the incentive for unemployed workers to accept new jobs. This phenomenon in turn depends on such matters as eligibility, generosity, duration, and regulation. If eligibility criteria are strict, the aggregate effect on unemployment is small. If weekly benefits are high compared with typical earnings in employment, the cost of unemployment to the unemployed will be low and the incentive to find a job will also be small. Payments that continue for a lengthy period of time also place less pressure on the jobless worker to find a job than payments that last for a shorter period of time. Also the effort made by authorities to make sure that the jobless make reasonable efforts to find and accept suitable jobs is significant.

The second of the four effects mentioned by Burtless is that generous unemployment insurance can

increase the probability that workers enter unemployment by quitting jobs because of the assurance of unemployment benefits. Workers might even be less inclined to perform to the best of their ability, leading to dismissals. Burtiess argues that jobless benefits can also affect unemployment by raising the equilibrium real wage. Trade unions, for example, might use the reliability of unemployment insurance to take more aggressive stances in wage negotiations. The fourth effect Burtiess notes is that payroll taxes to pay for unemployment insurance increase the employment costs borne by employers. The greater the benefits of unemployment insurance, the higher the payroll taxes. This increases the cost of hiring workers and leads to a decreased demand for labor. (Burtless, P. 108)

The "replacement ratio" is a concept for measuring the macroeconomic work incentives to workers. It is the ratio of net benefits received in unemployment to the net earnings received at work. The U.S. has replacement ratios that are much less than those in Germany and in the rest of Europe. The average weekly benefit level in the U.S. is not much less than in Germany, but the benefits last half as long, leading to the lower replacement ratio. (Burtiess, P. 114) This could be a contributing factor to the greater long-term unemployment problem that Germany has compared to that of the United States.

## **Regulatory Burdens**

Barriers to market entry in certain fields and government subsidies have been impediments to competition in German industry. Monopolies set up by the government are barriers to competition and dominate the market in such fields as telecommunications, utilities, and transportation. In the electricity sector, government regulations and monopolies have greatly increased electricity costs; the result is that costs are 70 percent higher in Germany than in the U.S. (Steinmetz, p. A5) These higher costs hurt the competitiveness of German industry. The effect of keeping the telecommunications monopoly, Deutsche Telekom, has been higher costs for consumers. Local phone charges are twice as high in Germany as in the U.S. (Fuhrman, p. 99) An example of the burden of regulation on German business is the time needed to get permission to build a new chemical plant. It took 6 months in 1985; it now takes 18 months. (Shlaes, "A Germany That Kills Science," p. A22)

Subsidies have the effect not only of keeping taxes high, but also of propping up inefficient industries. This is, in effect, corporate welfare with special interests lobbying the government for help instead of cutting costs and competing. These subsidies are mainly in the shipbuilding, steel, agriculture, and mining industries. An argument might be made to protect the shipbuilding industry for national security, but the other subsidies are just a form of protectionism and wind up costing the consumer/taxpayer more than they help the specific industry. Government subsidies, such as to the coal industry, amount to between 4-5 percent of GDP. (Bibbee, p. 35) The German government spends more on protecting these old Industrial Age industries than to support basic research.

The retail industry in Germany provides a good example of government overregulation. Laws prohibit stores from marking down the price of merchandise unless it was done simultaneously with other stores, which would defeat the purpose. This restriction is nothing but a stifling of competition among stores and is quite detrimental to consumers because there is an incentive for shopkeepers to keep prices high. Other laws mandate that all stores (with a few exceptions at tourist attractions) be closed on Sundays and three Saturdays a month and limit the hours that the store can be open during the week. In defense of these laws a trade union official was quoted as saying, "The right of 2.7 million retail employees to go home at the weeknight closing time of 6:30 p.m. clearly outweighs the desire of a few individuals to shop in the evening." (Shlaes, "Germany's Chained Economy," p. 119) This represents a serious attack on the rights of consumers to shop when most convenient and probably is one cause of the low level of consumer spending in Germany. The evenings and weekends are the most opportune times to shop because most workers are off from work. Pressure to deregulate the retail industry, however, has been

met with resistance. As Ulf Kalkman, co-chairman of the Retail Trade Association of Hamburg, remarks, "We'd love to leave everything as it is." (Burke, p. 8)

Other regulations, such as those on biotechnology, probably have more serious effects. Environmental regulations and public opposition to local plants have dealt a serious blow to the German biotechnology industry. The success of the Green party in recent times is indicative of the environmental mindset of the German people. In 1982, Hoechst A.G., one of Germany's largest chemical and pharmaceutical companies, invested \$38 million in a plant to produce human insulin but was forced to close because of political and public opposition. (Greens) At the same time, Eli Lilly of the United States developed the same chemical and exported to Germany what just as easily could have been produced there. As a result, Germany lags 5-8 years behind the United States in this key Information Age technology. Also, opposition from home has led many German chemical companies to move biotech research to neighboring France and close to the leading research universities in the United States. The opposition to the biotechnology industry is partly due to the public impression that the research resembles some of the genetic research done by Hitler earlier this century. It is also due to scare tactics and disinformation by radical environmentalists and ignorance on the part of the public. In reality, genetic engineering is a substitution for chemicals, such as herbicides and pesticides, that environmentalists despise. A genetically altered gene is immune to certain diseases and insects that previously forced farmers to use chemicals. (Shlaes, "A Germany That Kills Science," p. A22) The head of the molecular biology section at Schering A.G. (a Berlin-based pharmaceutical company), Dr. Wolf-Dieter Schieuning, laments, "If you say in America you're in genetic engineering, it's glamorous. People admire you. Say it in Germany, and people suspect you." (Benjamin, p. A1)

The opposition to biotechnology may be indicative of a bigger problem for Germany: at increasing hostility to technological and scientific change. There is even a German term for this phenomenon, *Technologiefindlichkeit*, or "hostility to technology." Public opinion polls show that Germans are less open to new technologies than Japanese or Americans. Jocher Hansen of the Allensbach Institute remarks "Today, you can express the feeling in public - 'I don't like technology' - without any reasoning. On television, you can always expect applause." (Benjamin, p. A1) This represents serious trouble for the country that led the world in technological advancement during the Industrial Age. A public hostile to technology will probably not be open to the increasing role of computers in people's lives and the efficiencies that come along with them. The computer software industry supports millions of jobs in the United States and is dominated by techno-wizards and computer hawks. Personal computer penetration in the U.S. is more than twice as great as in Germany. As of 1993, 28 percent of homes in the U.S. had personal computers, while only 12 percent of homes in Germany had them. (Fuhrman, p. 99) How can a German child who has never used a computer one day compete with an American child who grew up with computers? In this time of dizzying change and increasing global competition, technological leadership is the key to success.

## **Innovationskrise**

The Innovationskrise, or innovation crisis, has also been cited as another cause of the perceived decline in German competitiveness. Germany lags behind the United States and Japan in declaration of patents in high-tech industries. A report by Chancellor Kohl in late 1994 said that in microelectronics the number of German patents decreased by 40 percent between 1987 and 1992, while they doubled in the U.S. and increased by 30 percent in Japan. The Chancellor also saw similar trouble in computers and communications. (Shlaes, "Germany's Chained Economy," p. 121) One cause may be German regulation. For example, in the area of biotechnology, German companies must go through a lengthy process just to get approval to conduct an experiment, while in the United States, the only approval needed is for the final product. Wilfred Prewo of the Hanover Chamber of Commerce complains: "The Americans invent, the Japanese produce, while the Germans still debate ethics." (Shlaes, "Germany's

Chained Economy," p. 122) Another cause of the Innovationskrise might be the lack of a large venture capital market, which limits German entrepreneurship and prevents many start-up companies from being successful. The primary sources of funds for German companies are large banks. These banks tend to be conservative investors and prefer financing refinements to old technology rather than completely new ideas. These banks are also major stockholders in German companies and, by being too conservative, may hamper the ability of these companies to innovate.

## **Reunification and the Political Situation**

Reunification of East and West Germany was a great event for the people of Germany and a political triumph for the Kohl administration. However, the economic consequences are costly. There were two main mistakes made during the reunification process. First, there was an original inflated appraisal of the value of East German physical assets, which was compounded by stubborn reliance on that assessment when confronted by evidence to the contrary. During the Cold War, the East German economy was thought to be the strongest of the Soviet Bloc countries. However, during reunification the West German government would have been better off with a mindset of having to rebuild the East German economy from scratch. The second mistake was the extension of all West German law and regulation to the East. This included setting an exchange rate of two East German marks for one Deutsche mark, despite estimates that a more reasonable exchange rate was five East German marks for one deutsche mark. West Germany has enough trouble with its overtaxed and overregulated economic system, but productivity in the East was much lower than in the West at the time of reunification and remains so today. Instead of transferring the West German economic system to the East, one possible alternative would have been to use the East as a laboratory to promote reforms needed in the West, such as a low tax and low-regulatory environment. A comparison between the former East Germany and the Czech Republic since the fall of the Iron Curtain is striking. Although East Germany was supposedly the most advanced of the former Soviet Bloc countries, the unemployment rate today in the East is about 17 percent compared to only 3.5 percent in the Czech Republic. The difference is that East Germany imported an overtaxed, overregulated and high-wage model with corresponding low productivity, while the Czech Republic started from scratch and essentially let the market determine its wage levels. As a result of Germany's policy, unit labor costs in the East are actually 40 percent higher than in the West.

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