REVIEW ESSAY

The German Economy

Europe's Faltering Giant

ANTONY P. MUELLER

In *The German Economy beyond the Social Market* (Princeton, N.J.: Princeton University Press, 2005), Horst Siebert provides a profound and detailed analysis of the current state of the German economy. Siebert is in a unique position to carry out such a task, having served as president of the Kiel Institute for World Economics and as a member of the German government's council of economic advisors. He has also held a series of university positions in Germany and other countries.

Siebert characterizes the German economy succinctly as an open economy—exports amount to one-third of its gross domestic product (GDP)—with a strong industrial base, embedded in a tightly knit social-security system and accompanied by a government sector that absorbs half of the GDP when social security is included.

The starting point of Siebert's analysis is Germany's slow economic growth since the mid-1990s. After a rapid and relatively stable growth in the 1950s and 1960s, Germany's economic performance began to falter in the late 1970s. In the second half of the 1990s, growth rates declined further, and since the year 2000 growth of GDP per capita has almost come to a standstill: from 2000 to 2003, the annual rate of growth was only 0.2 percent. Productivity grew rapidly from the 1950s to the end of the 1970s, but began to decline after 1980 and slowed even more in recent years. The annual rate of growth of productivity declined from 2.1 percent in 1991–2000 to 1.2 percent in 2000–2003 (p. 3).

Antony P. Mueller is a professor of economics at the University of Caxias do Sul in Brazil.

The Independent Review, v. XII, n. 2, Fall 2007, ISSN 1086–1653, Copyright © 2007, pp. 279–283.

Siebert traces the German economy's weak performance to the growth of the welfare state, which has created a governmental presence and intervention that go beyond social security to encompasses the labor market and the regulation of various product markets and sectors of the economy. The labor market's inflexibility, high reservation wages, and a labor factor burdened with large social contributions produce persistently high unemployment rates in the neighborhood of 10 percent.

The German economy has two sides. On the one hand, it is highly regulated, particularly with respect to social and labor issues. On the other hand, the German enterprise sector is efficient and internationally competitive. Germany's industrial sector consists to a large extent of small and medium-size firms, the so-called *Mittelstand*. As Siebert explains, the important companies in this group are built around a technological idea and are technological specialists in their fields (p. 9). Private ownership by the entrepreneur typically plays an important role in these firms, and thus the "owner-entrepreneur is the driving force of the enterprise" (p. 9).

When national reunification occurred in 1990, the West German economy was in fairly good macroeconomic shape. Price stability had been achieved, the government budget was balanced, and the current account accrued a surplus equal to almost 5 percent of GDP. That economic flourishing led the government to underestimate drastically the burden that reunification would entail and caused it to commit "serious policy mistakes" (p. 19), such as exchanging the East German mark one to one for the West German mark (which implied an appreciation of the East German mark by some 400 percent), thus triggering unrealistic expectations that fed into excessive wage demands. In addition, West Germany's social-security system was imposed on East Germany. Instead of using reunification as an opportunity to overhaul the institutional framework of the "social-market economy," to make it more capable of meeting future challenges, the government granted East Germany a degree of social protection that had already become a heavy burden on the West German economy.

After World War II, West Germany constructed the so-called social-market economy. The basic idea was to have a competitive economic order safeguarded by social protection with minimum intervention in markets. "Market conformity, no intervention" (p. 31) was the motto of this "ordo-liberal" model, and the state's role was only to be the guarantor of the framework. Siebert shows in detail how this model has degenerated into a popular and almost populist social-welfare state. His preferred explanatory hypothesis concerning Germany's unimpressive economic growth is the "erosion hypothesis," which "links low growth to high unemployment and the failure of the labor market, as well as to unsolved problems in the social security system" (p. 67). These problems had become apparent before the reunification, but the short-lived reunification boom concealed their urgency in the early 1990s. They have come back with a vengeance since the mid-1990s.

The root of Germany's slow growth is high and sticky unemployment whose causes can be linked to the social-security system and protective labor laws (p. 69). With each recession since the first oil-price shock, unemployment has jumped upward,

with only a moderate decline in the following boom years. "The stepwise ratcheting upward of unemployment signals that Germany's institutional design for labor is malfunctioning. There are three major aspects of this problem: the institutional design of wage formation, the role of the reservation wage, and a systematic weakening of the demand for labor" (p. 70). In Siebert's view, these institutional factors are reinforced by a culture that more and more has adopted the "philosophy of reduced working time" (p. 84). Persistently high unemployment has put the social-security system under permanent financial strain, necessitating contributions that make labor more expensive and thus cause more unemployment. Furthermore, the extensive social protection may also be a factor in explaining Germany's low birth rates. An aging population will emerge as a major challenge for the German economy in the future, and as long as the social-security system creates extremely high opportunity costs for having children, most likely little will change.

Since the early 1960s, Germany has become an immigration country. One-tenth of the country's current residents have a foreign citizenship—approximately the same proportion as in the United States. Under Germany's social-welfare system, however, immigration is much less beneficial to the economy than elsewhere. The situation has changed greatly since the late 1940s, when West Germany (with a population of 48 million) swiftly integrated 7.9 million refugees into the labor market. Today, immigrants in Germany account for 17.4 percent of the unemployed and receive many kinds of government social benefits. "This poor integration of foreigners into the labor market reflects the fact that the lower segment of the German labor market, so important for immigrants trying to get an economic hold in their new environment, has dried up because of the informal floor of income provided by the government" (p. 171).

In opposition to the central ideas of the founders of the social-market economy, who saw the basis of a prosperous economic system in a competitive order, with government as the guarantor of the framework lending only a supportive hand, the economy in its present degenerated form stresses "uniformity of outcome" (p. 244). This condition not only weighs heavily on the labor markets, but also appears in the form of excessive regulation of the product market and certain sectors of the economy, such as banking and finance. It also affects human capital formation and technology policy, so that "even in the educational sector . . . the goal of equity has taken efficiency out of the German system" (p. 247). The largely private vocational-training system, with its dual elements of apprenticeship and vocational school, still operates effectively in providing firm-specific and general skills and serves as an important mechanism for socializing young people and integrating them into the labor market (p. 248)—something that cannot be said of the public-school system.

Siebert uses harsh words to describe the current state of Germany's university system. Its "central planning approach" (p. 254) to recruitment and its overall tendency to put equality above excellence have the paradoxical effect of producing a highly inequitable outcome powered by a "down-to-up redistributive machine"

(p. 253). Students are largely freed from paying tuition and professors from direct incentives and competitive pressures. Although an implicit aim of the German university system is supposedly social equity, the opposite has occurred (pp. 343–44), along with the additional effect that the system is no longer competitive internationally. "The administrative planning approach adopted with respect to German universities does not rely on the force of competition. Universities do not select their students, and students can select the university of their choice only within limits. Except for the intrinsic behavior of individual professors, universities and their departments are not really in competition with one another" (p. 344).

Notwithstanding the rising tax burdens and the increasing social-security contributions, the government has run up its debt substantially. The debt/GDP ratio has risen from less than 20 percent in the early 1970s to more than 60 percent in recent years and is now heading toward 70 percent. With the avalanche of pension and retirement claims forecast for the coming decades, the trend toward increasing government debt will remain in place and augment the feedback effects among budget deficits, tax and social-contribution burdens, and unemployment. Besides regulating product markets heavily, Germany also stands at the forefront of environmental protection, making economic activity less flexible and more costly.

Besides the reunification, another major policy event in recent years was the introduction of a common European currency, for which Germany was the major proponent. Moreover, the European Union has incorporated a number of former Soviet-bloc countries and now (2007) consists of twenty-seven member states. While meeting the challenges posed by these events, business firms have also had to adapt to the new international economic environment that globalization has created. Germans have thus faced an abundance of serious economic problems in recent years. Siebert concludes that in view of "Germany's poor performance in terms of high unemployment, low economic growth, the near-insolvency of the social security system, and the deterioration of the public finances, . . . the country needs a major change—an institutional big bang similar to the Erhard reform of western Germany in 1948" (p. 365).

Rich in statistical and other evidence as well as in the depth of its analysis, Siebert's book may serve both as an introductory text for the study of the current state of the German economy and as an in-depth analysis for the specialist. Details in facts and figures are compiled in a clear and reliable manner, creating a veritable handbook on the German economy. The problem areas and their ramifications are not news to the experts, of course; they have been discussed intensively in academic circles since the 1970s. Official and semiofficial institutions, such as the German government's council of economic advisors and the German economic research institutes, have published extensively on the issues. Only in the past few years, however, has a broader public recognition of the problems emerged.

Siebert wrote his book at a time when the feeling of malaise was most severe in Germany, in the doom and gloom years from the late 1990s to 2004. Then, surprisingly for many observers, Germany's economic growth rate increased in 2005, accel-

erated in 2006, and is expected to rise even higher in 2007. The German economy's current upswing is the result mainly of an impressive export performance, which has made Germany the world's leading exporter for three years in row. This performance is not entirely due to the reforms the Schroeder government undertook. Rather, the current recovery is mainly the result of the efforts of the German entrepreneur-owner middle-size companies, particularly of those that produce and market a specific technological product that gives them a unique competitive advantage on a global scale in their specific area. These *Mittelstand* business firms, in their capacity as subcontractors to the large companies, also help to make some German multinational companies highly competitive internationally.

Unfortunately, the current upswing may be short-lived. If so, the deeper structural problems that plague the German economy will emerge again even more fiercely. Should the current upswing last a few more years, new opportunities may arise for Germany to produce the "institutional big bang" and move the institutional framework massively toward a competitive system with less state intervention at all levels. If this opportunity should be missed again, however, the challenge will only return later in a more costly manner and under more severe conditions.