

IZA DP No. 1059

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Economy and a Return to High Employment**

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Discussion Paper No. 1059
March 2004

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ABSTRACT

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The year 2003 has witnessed several major reform policy initiatives in Germany intended to contribute to a solution to Germany's high unemployment problem and to improve the long-run sustainability of its social welfare policies. These economic reforms are discussed within a larger macroeconomic context.

JEL Classification: J68, E65, O52

Keywords: labor market reform, social policy reform, unemployment

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Irwin Collier¹

“If we are not successful in significantly lowering the unemployment rate, then we would neither deserve to be reelected nor would we even be reelected.”

Gerhard Schröder, *Der Spiegel*, Aug. 23, 1998.

In 1998 Gerhard Schröder had the luxury of running against the economic record of the last years of Kohl government. Candidate Schröder was quite aware that later in 2002 he would have to run on his own economic record. The German electorate yearned for a substantial reduction in unemployment, but all it got was an insignificant change. When Gerhard Schröder first became the Federal Chancellor in September 1998 the number of unemployed was 3.97 million. Four Septembers later in 2002 the number of unemployed had only declined to 3.94 million.

One prong of the 2002 election strategy of the Schröder team to deal with its unemployment problem was to attempt to shift the blame for the continued labor market stagnation to the weak state of the world economy. The other prong of the strategy was to appoint a blue-ribbon commission for the reform of the German system of employment offices. The commission claimed and perhaps even believed itself that its 13 module reform package would be capable of reducing the number of unemployed by half and that this goal could be achieved by the end of 2005. One can easily sense just how desperate the Schröder reelection campaign staff must have felt regarding the vulnerability of their unemployment flank in the months before the 2002 elections.

However history was to smile on the Schröder campaign as nature and international politics provided well-timed and much needed distractions from Germany's unemployment problems. The flood of August 2002 in East Germany was the sort of crisis needed to demonstrate that this federal chancellor could lead and dispense federal favor at will, while the international tensions over the growing Iraq crisis provided an opportunity for striking a pose for peace.

A triad of economic problems

The German proverb that misfortune seldom arrives alone completely captures the essence of present German economic difficulties. The chronic failure to achieve the full utilization of the nation's productive resources, in particular as seen in the high levels of unemployment we observe, is but one of three interrelated economic problems facing Germany. The second problem is that the mainsprings of the postwar German revival seem to have run down, vibrant economic growth has become a memory and is not part of the historical experience shared by the young generation. Nothing less than the strength of the underlying trend of Germany's ability to generate real income growth over the future long-run is the issue. The third of Germany's economic problems involves the sustainability of its tax-transfer programs and systems of social insurance. Schröder's Germany, much like Kohl's Germany before it, is in very serious trouble on all three counts and there is a growing sense that the day of reckoning is nigh.

The best way to get a sense of the scale of Germany's economic problems is to place them within a longer historical or broader international context. The urgency of large steps becomes much clearer once the magnitude of the problems is truly grasped.

The upward trend in unemployment in Germany has taken close to a full generation to get where it is today (Figure 1). Instead of roughly symmetric up- and downward fluctuations in the number of unemployed around a flat average number of unemployed, Germany has experienced an unrelenting upward ratcheting of unemployment from recession trough to recession trough. While some of the increase in unemployment can be seen to be reduced in each subsequent economic upturn, no economic recovery since the mid 1970s has been adequate to stabilize unemployment, much less reverse the upward trend that can be easily constructed by connecting either the peaks or the troughs in Figure 1. The high unemployment experienced in the East German states can be seen to have acted as a disproportionate upward shift to the trend and underscores the chronic increase in unemployment. Rather than reversing the trend, the Schröder government in its second term has also fallen victim to the trend increase in unemployment.

One of the problems of suffering a chronic condition is that the deterioration can be so gradual as to go unperceived. Gerhard Schröder's hand for reform was strengthened considerably following the announcement of the results of the OECD's Programme for International Student Assessment (PISA) in December 2001. Germany was unceremoniously lumped into a group of nations found to be statistically significantly *below* the average of the OECD countries.² Less than a year later, the president of the ifo Institute in Munich, Professor Hans-Werner Sinn, brought a similar point home with regard to Germany's relative economic growth performance.³ *Schlusslicht* (taillamp) was able to replace the metaphor of the *Reformstau* (reform jam) as the recurring theme of television talk shows and newspaper editorials.

Examination of the average growth rates for well over a decade now in the EU-15, U.S. and Japan in Figure 2 reveals an enormous variance from high-flying Ireland to the liquidity-trapped Japan. Alas it is true. The last place of the EU-15 for average economic growth goes to

Germany. It is small consolation that the sick man of Europe has only managed to hobble slightly faster than the sick man of Asia.

<< Insert Figures 1-3 approximately here >>

Having looked back in time and across much of the European continent, there is more bad news if we look into the German future as far as professional demographers claim to be able to see. Figure 3 reveals the workings of a demographic infernal machine that certainly has the potential to destroy existing unfunded systems of public pensions, health care insurance and insurance for long-term care. Plotted in Figure 3 are the historical as well as projected number of senior citizens (defined as those 65 years of age and older) and juniors (below the age of 20 years), both relative to the population in the working ages between 20 and 64 years of age. Similar trends are witnessed across the world so it is useful to put the German demographics in a comparative context. As the present time Germany's senior ratio is higher than 49 of the 50 U.S. states. While one is not surprised that Florida is, statistically speaking, grayer than Germany, most people are surprised to learn that within only a couple years, the senior ratio in Germany will actually pass that of Florida. These demographic trends pose problems for the sustainability of all systems of social insurance that are funded on a pay-as-you-go basis, i.e. the benefits paid out in a calendar period equals the contributions paid in by contributors during the same period. Either social insurance contribution rates need to be raised or entitlements cut for beneficiaries in order for such systems to stay in balance as the ratio of beneficiaries to the population paying into the system gets larger. This demographic trend is of central importance for pensions and long-term care systems and it is an important part of the story for the future development of aggregate health care costs (there is also a medical cost explosion worth worrying about). To the extent that unemployment benefits for older workers continue to be exploited as a bridge to span the gap

between active employment and pension eligibility, bad demographics in the future will add pressure on the unemployment insurance system as well.

While the litany of high unemployment, low growth and unsustainable systems of social insurance is bad enough, it is the interaction of all these problems that makes anything short of a broad fundamental reform of Germany's economic and social institutions unlikely to break the existing bad trends. High unemployment reduces contributions into the pay-as-you-go systems of social insurance. This puts upward pressure on the social contribution rates (Figure 4), and higher nonwage labor costs help to push up the cost of labor, weakening the demand for German workers. Dismal growth means that the natural increase in the demand for labor derived from the growth of production falls behind the reduction in the demand for labor as a consequence of productivity growth, i.e. low growth rates are jobless growth rates. Social entitlements outrunning contributions either push up the nonwage labor costs or force additional government spending to offset the shortfall (requiring budget cuts in other programs or tax increases). These last adjustments will simply aggravate unemployment or growth problems, when not both.

<<Insert Figure 4 approximately here>>

Since the 2002 election Germany's unemployment problem has worsened with the number of unemployed expected to average 4.4 million over the first half of the second Schröder term⁴ and the sustainability of many of the core social policy institutions of Germany's social-market economy are almost as much as in doubt as when Gerhard Schröder first took office. The Red-Green coalition has found itself in a precarious position regarding the economic policies needed to solve Germany's long and short term problems: they will be damned by voters sooner if they do (cut and restructure social entitlements) *and* will be damned by voters later if they do not (reduce unemployment).

The Schröder government knows that it needs genuine economic success in the form of a definite break for the better and 2003 has turned into a year of major and minor reforms for the German labor market as well as for its pension, health, and long-term care systems. For the German Left 2003 has been something of an *annus horribilis* as one sacred cow after another has been led to legislative chambers. Bismarck's famous analogy between the making of laws and the making of sausage is no less apt today. The slaughter of a sacred cow is not a pretty sight. This does not spare us the necessity of examining the proposed reforms in order to judge their ultimate contribution to solving Germany's economic problems that will have an impact on Gerhard Schröder's political future and more importantly his historical legacy.

Thinking About Unemployment

Rather than rush into a top-ten list of Gerhard Schröder's labor market reforms, a quick survey of basic labor market theory is useful in providing a framework to help us answer the ultimate question of whether all the changes will really add up to a significant reduction in German unemployment. There are two complementary ways of approaching the issue of unemployment. Each captures an important aspect of the labor market. The first approach uses the traditional concepts of supply and demand. Unemployment is seen as the result of having "the" wage too high to clear "the" labor market. The second approach views the labor market as a place where a process of matching individuals (everybody is special) to jobs (no two jobs are exactly alike) takes place. Unemployment comes from the fact that it takes time for those seeking jobs and those hiring to actually find each other.⁵ We can consider the Schröder labor market reforms of 2002/03 by considering their impact on labor demand, labor supply and the matching process, respectively.

While there are die-hard Keynesians of the old school who continue to believe that Germany's unemployment problems are completely independent of the cost of German labor and that the high unemployment is solely a matter of an inadequate aggregate demand for goods and services, a glance at Figure 5 and Figure 6 reveals that the data do show a definite negative relationship between real wage growth and the demand for labor in the manufacturing sectors of Germany, France and the U.S.⁶ The real hourly labor compensation indexes computed for these countries from official country data by the U.S. Bureau of Labor Statistics include wage costs and nonwage costs such as social insurance contributions, vacation and holiday pay and they have been adjusted for changes in the purchasing power of nominal wages using an index of consumer prices. The indexes of hours in manufacturing are shown because they capture the actual volume of labor that is demanded at the hourly real compensation rate seen in Figure 5. Comparing the two figures with each other, one can appreciate the dilemma of union leaders in France and Germany. They have enough power to negotiate a high real wage growth, but given the high wages, they lack the power to force employers to maintain, much less expand payrolls. In comparison we see that the slow wage growth in U.S. manufacturing where unions are weak was accompanied by an expansion in the volume of labor employed. High real wage growth in French and German manufacturing and the fall in aggregate hours is not a statistical artifact. One presumes that the unemployed in France and Germany have a preference for labor demand to grow as it has in the U.S. while the "insiders" with jobs in France and Germany can look back at the real wage increases rather sanguinely—it is nice to still have a well-paid job. The lie that German unions have lived by (*Lebenslüge*) is that their high wages are the purchasing power that guarantees the employment of others. The reality is that their wage policies have played a critical role in the story of why there are not nearly enough jobs to go around. Almost all of the attention in German public debate has been limited to the role of nonwage labor costs rather than on the

much larger share of total labor costs accounted for by wage costs. It appears that the laws protecting the wage cartels of organized labor and organized associations of employers are one sacred cow that continues to ruminate in peace during the fury of the politics surrounding the Schröder government's Agenda 2010.

<<Insert Figures 5-7 approximately here>>

The relationship of unemployment and the supply side of the labor market can be illustrated using images of floors and wedges. The fundamental principle of a market economy to keep in mind is that exchange is *voluntary*—people will not work if they do not choose to work and they will not be hired if employers do not choose to hire them. The notion that unemployment is always and everywhere involuntary is an oversimplification that may be warranted when discussing pathological cases such as the Great Depression or for particularly depressed areas in the new states of Germany, but misses much of the reality in normal times, good and bad. The question for labor supply is what are the options that the unemployed in Germany have to choose from?

The “floor” in question is established by the value of time in non-market activities (which include paid employment in the “black” economy) and social entitlements that replace lost wages. As the advice columnist might ask “Are you better off with work, or without it?” Even without a statutory minimum wage, there is an effective floor for wages at which employers can effectively hire workers that is in part determined by a country's system of income support for its unemployed. It is impossible to force someone to accept a low paying job, if they feel it is not a better alternative to some combination of work at home, work in the informal economy and receiving unemployment compensation. Similarly it is equally impossible to force employers to hire people when this effective wage floor exceeds the value of a potential worker's productivity

in the new job. Hence safety nets can stabilize the income of low-skilled unemployed workers while at the same time they destroy the demand for low-productivity workers.

The image of the wedge captures the economic difference between what you see on your gross pay statement with what you get to spend once taxes, social insurance contributions and unemployment or welfare benefits cuts are figured in. Relevant for the employer is the gross number and relevant for the person deciding the value of going to work is what is left over, which because of the partial or total loss of social entitlements upon accepting employment can be considerably smaller than what we normally think of as take-home pay. Consider the extreme case (which is much closer to the reality experienced by low-skilled long-term unemployed than “extreme” might suggest) of a 100% implicit tax on market work, i.e. an unemployed worker sees the choice as no job vs. working with no difference in household net income. *Homo faber* might choose to work instead of remaining unemployed, but *homo sapiens* in Germany would choose the safety net. Part of Germany’s unemployment problem is that it has allowed a confiscatory implicit tax rate on market work for its unemployed, low-skilled population.

The wedge for a normal working family (one member of the household has an average full-time job in industry, the other earns 33% of the average, two children) in several countries can be seen in Table 1 which is based on OECD calculations, with German data updated by the ifo-Institut in Munich. The table gives the *marginal* burden on labor value-added of taxes and social insurance contributions together so that one is able to compare just how much of a bill for labor service, e.g. for a housepainter, succeeds in becoming net income for someone providing that service.⁷ The marginal burden of taxes and social insurance contributions in Germany puts it at the top of the table, even ahead of Scandinavian countries known for their large public sectors.⁸

Table 1. International comparison of shares of marginal value-added by labor for taxes, social insurance contributions and increase in worker income

	Wedge				Net increase in labor earnings
	Value-added tax/sales tax	Employer contributions to social insurance	Employee contribution to social insurance	Income tax	
Germany*	13.8%	15.0%	15.0%	22.9%	33.3%
Sweden	20.0%	19.8%	4.2%	17.0%	39.0%
Denmark	20.0%	7.2%	0.0%	33.3%	39.5%
France	17.1%	24.2%	7.9%	10.0%	40.8%
U.K.	14.9%	9.3%	7.6%	16.7%	51.6%
U.S.**	5.7%	6.7%	6.7%	19.2%	61.7%

* West Germany, 2004.

**Detroit, Michigan.

Source: Hans-Werner Sinn (2003, p. 300) using OECD and ifo-Institute estimates.

The second framework for analyzing unemployment regards people searching for jobs and vacant jobs “searching” for people as a matching problem. Thus a spell of unemployment is seen to be the time it takes an unemployed worker to search and find (or be found) and policies for reducing unemployment focus on shortening the length of unemployment spells.

The idea that an economy’s labor market can be seen as a place where heterogeneous job vacancies are matched to heterogeneous workers seeking new jobs goes back at least to the 1940s when William Beveridge proposed to define full employment for an economy as the state when the number of vacancies slightly exceeds the number of people seeking work. Because of costs to searching for both sides of the labor market, the matching process takes time and unfilled jobs and unemployed workers will coexist at any point in time.

The plausibility of such a definition comes from the memory of signs “We are hiring...” at factory gates during times of growing economic prosperity and growing lines of people seeking work or unemployment benefits at the local labor office during times of recession or

depression.⁹ More important for understanding much of the labor market reform discussion in Germany is the implicit inverse relationship suggested in this definition between the number of jobs seeking workers and the number of workers seeking jobs. Plotting job vacancy rates together with unemployment rates on a graph, economists have named the pattern they observe a “Beveridge Curve”.

When one looks at the data on vacancy rates and unemployment rates in Germany (Figure 7), it is clear that reality is more complex. Connecting the annual dots, one discovers a series of “Beveridge Loops” rather than a simple Beveridge Curve with a strong and simple inverse relationship between the two rates. Fortunately one does not have to torture this data too hard to have it tell us a tale involving at least three different Beveridge Curves, (1976-1984), (1985-1994) and (1997-2000). The movements down and to the right along any given Beveridge Curve occur during an economic downturn when we observe more unemployed workers chasing fewer unfilled vacancies, whereas movements up and to the left take place during an economic expansion with more unfilled vacancies chasing fewer unemployed. What is overlooked in the simplest formulation of the Beveridge Curve is (i) that structural change in the economy could increase the mismatch between those out of work and the growing new industries seeking workers with significantly different skills and training, and (ii) institutions of social insurance that provide income support for longer periods and at a higher levels generate incentives to take longer to look for work and hope for better alternatives. Either or both stories would be sufficient to explain the outward drift of the German Beveridge Curve.

Something else that we see from the Figure 7 is that adding the East German post-wall labor market to the story of the Beveridge curve does not really change the qualitative movements along the Beveridge curve. However German unification (unsurprisingly) added an extra rightward shift to the relationship on top of the large shifts that occurred over the fifteen

years before German unification and the shift observed in West Germany during the decade of the 1990s.

About Face, Forward March

Considering that the first Schröder government began business by undoing relatively modest economic reforms that had been passed during the last years of the Kohl era¹⁰, the shift into high gear with respect to economic reform going into the second Red-Green government becomes all the more remarkable.¹¹ Even the timid Riester reform of 2001 that brought the beginnings of government supported individual retirement accounts only managed to take a relatively simple concept (some of your saving now for retirement would be subsidized) and added enough layers of regulation to turn a surefire retirement product into a less than popular way to save. In short, at the beginning of 2002 nobody really expected a reform year like 2003 from a government that seemed to think that all what Germany really needed was a crackdown on “pseudo-self-employment” (i.e. the subcontracting of work to people who are formally self-employed but only working for a single client) in the interest of keeping businesses and individuals from working around the statutory systems of social insurance to avoid paying contributions.

But that was all before a Federal Accounting Office report to the Federal Ministry of Labor in January 2002 in which five employment offices under suspicion had been found to have falsely or incorrectly reported job placements in 70% of 5100 cases. Even the most cynical critics of government waste were shocked at the degree of the misreporting. No wonder Germany was suffering such high unemployment when clerks in the labor offices are able to overcook the books like this! It was of no matter that the little tail of the Federal Labor Office was not wagging

the big dog of German unemployment. This scandal forced Gerhard Schröder's reform hand at the start of his re-election year.

If voters could not be shown evidence of a turnaround in the German labor market in 2002, it was at least necessary to offer a promise of coming full-employment attractions. Given the utter failure of roundtables like the unsuccessful Alliance for Jobs to rise above the level of a heated *Stammtisch* debate of regulars in the neighbourhood pub, the Schröder government sought refuge in a blue-ribbon commission.

The Hartz Commission

The 15-member Commission for the Reduction of Unemployment and the Reorganization of the Federal Labor Office was constituted on February 22, 2002 under the chairmanship of Dr. Peter Hartz, Labor Director on the Board of Management of Volkswagen. The Commission included management consultants, company human resource managers, union and employer association representatives, communal politicians and a couple of academics. Unlike the Rürup Commission that would be named at the end of the year to prepare reform proposals for the German systems of social insurance, the Hartz Commission charged into the economic reform fray without the benefit of a single professional economist which helps to explain that the final report presented in August 2002 was as far from being dismal as it was from being scientific. The early claims of the Commission that its proposals could reduce German unemployment by two million people by the end of 2005 seem rather absurd with the advantage of hindsight one year later. Going into the final month of the 2002 federal election, the promise of the Hartz Commission reform proposals seemed merely incredible.

The 13 modules of the final report of the Hartz Commission were primarily designed to transform a government bureaucracy that processed unemployment claims and administered the

unemployed into a new kind of public service agency committed to the reduction in the time it takes to match a person looking for work to a job. Part of the accelerated matching would come about from requiring advanced notice of impending cases of unemployment to be given to the local labor offices so that job placement activity could be initiated before a spell of unemployment would even begin and early filing requirements imposed upon the unemployed themselves. Another part of the accelerated matching would be the result of proposed simplifications in procedures that would release more of the 90,000 employees of the Federal Labor Office from routine administrative tasks so they too would be available for helping the unemployed find jobs. Yet the overwhelming impression one takes away from a reading of the Hartz Commission's detailed proposals for the implementation of this structural transformation of low-keyed paper shufflers into dynamic headhunters in the service of the unemployed is that management consultants are actually worse than their reputation.¹²

While the mandate for the Hartz Commission was mostly limited to the organizational restructuring of the Federal Labor Office, some of its final recommendations in fact go beyond proposals to improve its core function of finding jobs for the unemployed to include proposals to expand opportunities for work free of the scent of public make-work projects. Personal Service Agencies as independent units in the new JobCenters¹³ are to become active in the market for temp jobs. Mini-jobs with reduced social insurance contributions are seen to serve the dual purpose of bringing some unreported jobs out of the shadows and creating new jobs in an expanded low-wage sector. The *Ich-AG* program (roughly "Me, Myself & I(nc)") is to provide a supported entry into small-time self-employment as an option for the unemployed.¹⁴

The consolidation of unemployment assistance for the long-term unemployed with public assistance for able-bodied persons in working age has turned out to be one of the more controversial recommendations of the Hartz Commission because it involves the reduction of

unemployment assistance to the lower public assistance benefits. Also controversial are recommendations for making it increasingly costly for recipients of unemployment benefits to refuse an offer of work judged suitable for them.¹⁵ It could even turn out that reducing the size of the unemployment benefit for the long-term unemployed (a key element of the income floor discussed above) and the toughening of the sanctions for non-compliance could make a significant difference in the labor market choices made by the unemployed.

Contemplating the rightward drift of the Beveridge Curve in Figure 7, it was perhaps only natural to dream of pushing it back in a grand act of labor market reform, i.e. for the same number of vacancies having fewer unemployed. The Hartz reforms have been sold as a package that is in effect supposed to shift the Beveridge relationship back to where it was some twenty years ago. There are plenty of good reasons for transforming the Federal Labor Office from a government agency that exists “to administer the unemployed” (matching them to their unemployment entitlements) into a public service agency that provides the service of job placement. However, expecting to achieve a substantial reduction in unemployment through an administrative reform of the Federal Labor Office is like having a director of a cruise ship with 80% widows and 20% widowers who thinks that the way to get many more couples dancing would be to keep widowers in close proximity to the dance floor. Germany has a problem with a shortage of job vacancies relative to the demand for jobs by the unemployed. Most of the Hartz Reforms promise little more than a more effective way to manage that shortage.

The Hartz Commission helped Gerhard Schröder defuse the scandal in the Federal Labor Office in time for his reelection and it helps us mark a turning point in the reform rhetoric of the Schröder government. It also provided a model for the Greens who extracted a concession for their willingness to sign off on the increase in the contribution rate for the statutory pension system that their SPD coalition partners badly wanted: there would be a new blue-ribbon

commission, one that would recommend reforms needed for the financial sustainability of the German systems of social insurance.¹⁶

The Rürup Commission

On November 21, 2002 the 26 members of the Commission for the Financial Sustainability of the Social Security Systems were officially named by the Minister for Health and Social Security, Ulla Schmidt.¹⁷ Professor Bert Rürup, an expert on the economics of pensions (not infrequently referred to as the “Pension Pope” by the German press) and a member of the Council of German Economic Experts, was appointed the chair of the new commission. In addition to several academic heavyweights in the fields of public finance and social policy, the Rürup Commission had ample representation of members from the governmental-social complex and union representatives such as the outspoken Dr. Ursula Engelen-Kefer, deputy chair of the DGB. Conspicuously excluded were representatives from associations of health providers. The Commission first met officially on December 13, 2002 and was originally expected to deliver its final report to the government in October 2003.¹⁸

The mixture of policy positions brought into the Rürup Commission by its members was extremely volatile from the start. In less than one month from its first meeting Rürup had to publicly scold a few of his fellow Commission members for talking out of school.¹⁹ The next months would be far worse when leaks to the press from the Rürup Commission began to upstage the Chancellor’s efforts to set his own reform agenda. At the end of March 2003 Gerhard Schröder lost his patience with the Commission (it was not his child after all) and explicitly threatened to disband it if the members continued to debate in public directly or indirectly before their report was complete.

In late April 2003 the Commission presented an interim set of recommendations which included a proposal to begin increasing the retirement system's "normal retirement age" from age 65 to age 67 in one month increments beginning in 2011. This would be one of two key elements in stabilizing the pension contribution rate in 2030 at a level of no more than 22%. The Commission was able to justify this step as matching the expected increase in longevity of the German population over the same period of time. The second element is a so-called "sustainability factor" added to the pension index formula to adjust future pension increases (downwards!) for adverse changes in the age composition of the population as well as for changes in labor force participation. The bottom line for pensions and contribution rates from the combined impact of these changes along with the maximum use of the Riester pension accounts assumed by the Rürup Commission can be seen in Table 2.

The calculations of the Rürup Commission indicate just how difficult it turns out to be to get nonwage labor costs back under control once things have taken a dramatic demographic turn for the worse. At the present time the joint employer-employee contribution rate for someone with average earnings of 2435 € per month (gross) is 19.5%. The so-called "standard pensioner" who has worked 45 years and earned exactly the average of all covered employees in each of those 45 years is 1170 € per month which is equal to 48% of that average monthly paycheck of average employees paying into the pension system now.

Table 2. Pension Reform Scenarios à la Rürup

Estimates are for an insured employee receiving average earnings in every working year.		
	2003	2030
Pension contribution rates		
Current law	19.5%	24.2%
Reform Scenario	19.5%	22.0%
<i>adding to reform scenario</i>		
4% Gross Riester pension contribution	23.5%	26.0%
2.8% Net Riester pension contribution (after subsidy)	22.3%	24.8%
Standard monthly pensions (in constant prices of 2003)		
Current law (45 years of contributions)	1170 €	1496 €
Reform Scenario (45 years of contributions)		1429 €
Reform Scenario (46.7 years of contributions)		1482 €
Riester pension		233 €
Total retirement income = Pension from 46.7 years + Riester pension from 4% contribution		1715 €
Gross Relative Pension Ratios (standard monthly pensions divided by average gross monthly labor income)		
Current law	48%	41.9%
Reform Scenario (45 years of contributions)		40.1%
Total: More working years + Riester pension		41.6%
Reform Scenario (46.7 years of contributions)		48.1%
Average gross monthly labor income (at prices of 2003)		
	2435 €	3567 €

Source: Bundesministerium für Gesundheit und Soziale Sicherung. *Nachhaltigkeit in der Finanzierung der Sozialen Sicherungssysteme. Bericht der Kommission*. Berlin. August 2003.

The Rürup Commission has assumed full participation in the Riester pension reform by everyone. Furthermore, by increasing the working life of the cohort that retires in 2030 by 1.7 years, a combination of a public pension from the Rürup reformed system together with a private Riester pension would result in retirement income equal to 48.1% of the forecasted average gross monthly labor income of covered employees in 2030. So from the point of view of the relative position of the newly retired household in 2030, things would look much like they do to the newly retired pensioner in 2003.²⁰

We can see from Table 2 that there would be a 4.7 percentage point increase in the contribution rate forecast from a simple scenario of keeping the current system as it is in 2003, subject to the constraint of the balance between revenues and expenditures that characterizes the pay-as-you-go system. If the Rürup Commission's recommendations that the working years be extended and the sustainability factor be included in calculating future pension increases are both implemented, the increase in nonwage labor costs accounted for by pension contributions will increase only 2.5 percentage points. This is just over half of the increase for a continuation of the status quo rules.

The 2.2% difference (i.e. 4.7% increase without Rürup reforms less 2.5% increase with Rürup reforms) can be decomposed as follows: the sustainability factor in calculating the size of future pension increases accounts for 1.4% of the difference, the increase in the normal retirement age of 67 accounts for another 0.6%, and the proposed shift of pension increases from July 1 to Jan 1 of the following year is worth 0.2%.

A forty year old German with average earnings reading the Rürup Commission's report whose goal is to have a pension equal to slightly half of average labor earnings in 2030 will have to start putting 4% of labor earnings aside for the Riester pension quite independent of whether

all the pension recommendations of the Rürup Commission are carried out or not. Expressed in terms of intergenerational burdens, the 2.2 percentage point reduction of nonwage labor costs for the active generation in 2030 will cost our average forty-year old 1.7 years of working to a later retirement. This is not really the stuff of a senseless demolition of the social market economy, though one would hardly guess it judging from the reaction of the union representatives in the Rürup Commission who refused to sign off on the recommendations.

The Rürup Commission was not even able to come to a majority opinion on the issue of health insurance reform. In the end the Commission proposed two competing models of reform for the political system to choose from. The first model, called a citizens' insurance (*Bürgerversicherung*), was the brainchild of the health economist Professor Karl Lauterbach, a member of the Council of Health Experts and trusted adviser to Minister Ulla Schmidt. The proposed citizens' insurance would involve an expansion of the present statutory health insurance system to absorb the career civil service and self-employed who would be compelled to join the wage and salary employees currently in the system. Furthermore health insurance premiums would be assessed on rental and interest income as well as on labor income. The ability to opt out of the statutory health insurance system to obtain private insurance at a sufficiently high income would be abolished. The second model, the flat-rate insurance premium with redistributive corrections through the tax system to prevent economic inequities, was favored by Rürup. Under the first model, the health insurance portion of the wedge between gross and net labor income would become smaller and grow more slowly over time whereas the second model would eliminate that portion of the wedge with health insurance contributions not influencing on the margin decisions to work or to hire.

Which of the two models will be closer to the course actually attempted by the Red-Green coalition remains to be seen. With the experts divided, policymakers have little choice but to trust

their political instincts. A “citizens’ insurance” has a natural ring to it that appeals to the vast majority of Red-Green voters without even getting into details. It promises what appears to be equality: no special treatment for the career civil service and no escape into private health care for those with very high incomes or the self-employed. It promises what appears to be solidarity: not just labor income up to the present level but income from assets and higher labor incomes would become subject to health insurance contributions. And perhaps most important, it is recognizable to everyone inside and outside of the current system. With regard to the problem of the upward creep of nonwage labor costs, the citizens’ insurance proposal promises only temporary relief at best. The bad demographic trend will reassert itself later with rising contribution rates on labor income again becoming a problem.

The competing proposal of flat-rate health insurance premiums with adjustments in the income tax system to prevent unwanted distributive consequences is at a competitive disadvantage in several ways. The trouble with this model is that it combines the disadvantage of a clumsy name (*System pauschaler Gesundheitsprämien mit steuerfinanziertem Einkommensausgleich*) with unfamiliarity. It is almost as though the economic engineers never thought of consulting with artistic social designers to create a social insurance product that functions, attractively fits with the other social policy “appliances” and is user-friendly. This is a pity, since the Rürup proposal represents a bold way of eliminating the wedge of health insurance contributions in labor costs altogether. It also would signify an equally audacious shift in social policy that would attempt to separate the issue of income distribution from issues of an allocative nature.²¹ However, one knows from the example of the negative income tax that it can take a long time for the work of academic scribblers to be accepted in the polite company of those who actually decide policy.

The ultimate choice between these two long-term health insurance reform proposals is like the ultimate choice on the normal age of retirement, both are decisions that will have little impact on the course of unemployment in Germany over the next five years. To win the 2006 Bundestag elections, Gerhard Schröder will need to worry more about reviving the German labor market. Sustainability is good, electability is better.

Agenda 2010

The Agenda 2010 (*zwanzig-zehn*) was announced by Gerhard Schröder in his speech before the Bundestag on March 14, 2003. The agenda is a package of policy proposals aimed at achieving full-employment in Germany by the end of the first decade of the 21st century, reviving economic growth and reestablishing financial sustainability for German social insurance institutions. A few months later the SPD signed off on the Agenda 2010 at its June party conference with 90% of the delegates approving the resolution.²² Because of the enormous public attention given both the Hartz and Rürup Commissions, there were few surprises in the reform measures found in the Schröder reform agenda. And yet it has become clear as its parts have been molded into legislation that the whole of the Agenda 2010 marks the beginning of a serious willingness to redefine the German social market economy.

Reduction in the duration of unemployment compensation benefits

One important deviation from the Hartz proposals is that Agenda 2010 included a significant reduction in the duration for the full unemployment benefit. There is widespread agreement among economists that an entitlement to a long duration of unemployment compensation will have an impact on the intensity of job search and the willingness of an unemployed person to accept a job offer. For these reasons the duration of full unemployment benefits (unemployment

compensation) is being significantly reduced to a maximum of twelve months (exception: workers above the age of 55 will be eligible for a longer duration of 18 months).²³ This change reverses a trend that began in the mid-1980s that eventually led to a 32 month entitlement for unemployment compensation for a 57 year old. Many businesses were able to exploit this long benefit duration to work out early retirement packages that enabled them to shed older employees with the unemployment insurance system “sharing” in the cost of the early retirement package.

Consolidation of long-term unemployment assistance with public assistance

Unemployment compensation serves as the first line of defense for falling household income in the event of unemployment, providing benefits (60-67% of last net pay) that permit a smoothing of a household’s consumption. The second line of defense in Germany after unemployment compensation is exhausted has been a secondary unemployment benefit, unemployment assistance, which is lower than the unemployment compensation (unemployment assistance is 53-57% of last net pay) though higher than public assistance. Like public assistance, unemployment assistance has been means-tested and is of unlimited duration. Both public assistance and unemployment assistance function as safety nets to catch the long-term unemployed. The essential difference has been that unemployment assistance was the net for recipients of unemployment compensation to fall into once they had exhausted their benefits, whereas public assistance remains the lowest social safety net to catch everyone else. From a functional standpoint this distinction has separated people of working age and capable of work into those reporting to the local employment offices (where job placement, training, advice was provided) and those reporting to the welfare office which can only refer clients to the employment offices for placement assistance. From a fiscal standpoint the unemployment assistance benefits were paid from the unemployment insurance system (responsibility of the

federal level of government) and the public assistance benefits were paid for by local governments so consolidation of the two programs has significant implications for the division of social responsibilities in the German federal system as well.

The consolidation of unemployment assistance and public assistance for all able-bodied people in working age paying a benefit equal to that of public assistance has been designated “unemployment compensation II.” One presumes the name of the previously higher paying benefit was chosen to paper over the de facto reduction in benefits entailed for recipients. In addition unemployment compensation II would come with stricter sanctions for the refusal to accept a job placement from the employment office. Reasonable exemptions are to be granted for retirement assets or owner-occupied housing in determining eligibility for the unemployment benefit II to avoid creating unwanted disincentives for saving. Limits to allowable labor earnings not subject to automatic benefit reductions are also to be expanded so as not to undermine incentives for accepting minor work.

This reduction in the unemployment benefit for the long-term unemployed together with a strengthening of sanctions for refusal to accept a job placement constitute an even greater change in the terms on which unemployed can be hired than the reduction in the duration of unemployment compensation. Should experience prove that the resulting labor incomes are such as to result in a working poor, then we can expect the scientific discussion on wage-subsidies to finally pour over into further labor market reform.²⁴

Employment protection

This item provided Gerhard Schröder some embarrassment since it forced him to admit that his government had made a mistake in reversing the Kohl government’s relaxation of the employment protection laws for small businesses (those between six and ten employees). By

reintroducing the old threshold for the full application of employment security laws to five employees, an enormous barrier for a business with fewer than five employees to expand had been put back in place. Should such a small company hire enough to have even one new employee above this threshold, the entire force of employment protection laws²⁵ would apply to all employees, both old and new. The proposal in the Agenda 2010 is to make this threshold more gradual so that the hiring of a couple of workers on fixed-term contracts would not immediately have consequences for the contract terms of the employees already there.

A reduction in the list of social criteria to govern the selection of employees for discharge when staff reductions become unavoidable will make it easier for businesses to keep younger and/or high performance employees on the payroll during hard times for the firm. Also measures are being introduced to help avoid the necessity of going to a labor court when someone is dismissed from a job through established procedures for severance pay in lieu of legal redress. To the extent that these reforms actually help to reduce the costs of adjustment of a firm's workforce to changing conditions, we can expect a greater willingness to hire new people. It would be wrong however to underestimate the ability of the labor courts and labor lawyers to protect the inflexible status quo here.

Long-term unemployed

For structurally disadvantaged regions, i.e. particularly for most of the new states, public works programs in those regions will be continued. The Agenda 2010 established a large-scale program in which federal and local levels are to cooperate in creating public works jobs for the long-term unemployed that will include opportunities for retraining²⁶. The program which will run through the summer of 2005 is expected to support about 100,000 long-term unemployed over the age of 25.

This item in the Agenda 2010 amounts to little more than a meager bone thrown to the eastern states. In fact voices in the East are becoming louder that national policymakers are yet again failing to address the specific circumstances of East German unemployment. In a recent interview Saxony's premier, Georg Milbradt, provided a disturbing assessment of what the Schröder reforms really mean for the eastern states:

The most you can say for Hartz reforms up to now is that they are good for the sunny day problems of the West. They don't address the special situation in the East of significantly higher structural unemployment and structural job shortages. Cutting unemployment assistance, which is paid for by the federal government, to the level of public assistance is a pure fiscal operation. The federal government will save money but that doesn't create a single job in the East. This has to be changed. Incidentally, the federal government is going to pay itself a larger share of turnover taxes as compensation for consolidating public assistance and unemployment assistance. It will actually come out ahead in the deal. The federal government will be pulling more money out of the East than it will be saving the local governments here in public assistance. In the East there are many recipients of unemployment assistance and few people receiving public assistance relative to the West. So East Germany would be forced to take a double hit from the current Hartz reforms.²⁷

Pensions

The Rürup Commissions recommendation for the introduction of a sustainability factor in determining future pension entitlements (i.e. lowering future pension entitlements in the interest of preventing an explosive increase of contribution rates paid by future working generations) was included in the Agenda 2010 passed by the SPD party conference. However the Schröder government has backed away from the commission's recommendation to increase the normal retirement age for the statutory pension system to 67 years. Instead the Red-Green coalition will look for ways to increase the effective age of retirement to bring it in line with the current normal retirement age of 65.²⁸

Miscellaneous other measures

Liberalization of master craftsman regulations. Earlier in 2003 the government approved a plan that would abolish the mandatory apprenticeship and master craftsman certification in 65 skilled trades. Previously a journeyman who did not have the master craftsman certificate was not allowed to set up an independent shop. This liberalization is limited to skilled trades such as tailoring or tile-laying where no issue of public safety could be put forward for the restriction.²⁹ These changes have a symbolic importance that go beyond their actual economic impact. Pre-industrial institutional remnants in a post-industrial economy are quaint in the way trolleys in San Francisco are quaint. However the master craftsman regulations serve no purpose other than the restriction of supply of services to protect the incomes of the master craftsmen and need to yield the right of way to competition in markets for goods and services.

Vocational training. Should German business collectively not offer sufficient opportunities for young people to enroll in apprenticeship training, a fine is being considered for those companies lacking apprenticeship programs. The Schröder government hopes that this can be organized through the skilled trade associations but failing a satisfactory result, legislation is threatened. While this sounds like a measure to combat youth unemployment preemptively, it is more likely just a sop for the left-wing of the SPD to show that the government is as willing to stick it to businesses as it is to the long-term unemployed.

Sick pay. The insurance costs for sick pay beginning in the seventh week of illness will be shifted to the employee entirely, resulting in a saving for the employer. This change will result in a .4% increase in the health insurance payment for employees participating in the statutory health care system. One of the difficulties in cutting back on the benefits provided by the statutory

health insurance system is identifying blocks of benefits that are not intricately part of the core of basic health services. Since this benefit has nothing to do with health care per se, it was easy to isolate from the health insurance system.

Tax reductions. The planned third stage of tax cuts originally planned for 2005 are to be moved forward to 2004. As a result the initial income tax rate would decrease from 19.9% to 15% while the top rate would decrease from 48.5% to 42%. Altogether the tax cuts are estimated to increase household disposable income by €21.8 billion. To minimize the budgetary impact of the tax cut the government plans to also significantly cut subsidies paid to businesses and through the privatization of government-held properties. The details of how much of what might be cut where in Germany still need to be hammered out between the opposition controlled Bundesrat and the Red-Green controlled Bundestag.

Having discussed fiscal issues in the long-term context of the sustainability of the German systems of social security, the East/West implications of the consolidated unemployment compensation II, and tax reform, now is a good time to consider the macroeconomic context of Schröder's economic reforms.

Traditional Monetary and Fiscal Policy Instruments: Locked Away, Not Helping Economic Reform

Germany's slide into disappointing economic performance had begun long before the Delors roadmap to European Monetary Union was agreed upon in 1989 so that losing the DM (or gaining the euro) is clearly not the root cause of most of Germany's economic problems.³⁰

However, the loss of an independent German central bank and the addition of significant fiscal policy constraints as enshrined in the Growth and Stability Pact mean that Germany has lost a capacity for demand management that could be of considerable political use in reducing some of the unavoidable pain involved in the implementation of the labor market reforms of Agenda 2010. The problem facing the Schröder government is that the vast majority of reforms promise positive impacts that only unfold over a considerable number of years, whereas the immediate costs, e.g. of a reduction in the old unemployment assistance to the new Unemployment Assistance II, need no time for their pain to be felt by those whose social entitlements have been cut. A deliberate and coordinated use of monetary and fiscal expansion that would result in a strong surge in labor demand in Germany is ruled out by the charter of the European Central Bank as well as by the deficit and debt criteria of the Stabilization and Growth Pact.³¹

In its most recent *World Economic Outlook* (September 2003), the International Monetary Fund warned of a genuine possibility that Germany could find itself in a Japanese-style deflation. Implicit in that warning was less a direct criticism of Germany than of the European Central Bank's monetary policy and of the general fiscal tightness throughout the Euro area. Figure 8 shows the direction of monetary and fiscal policy changes for years immediately preceding Schröder's reelection for Germany and in several other advanced industrial countries. Points to the lower left indicate an expansionary impulse coming from both fiscal and monetary policies and points to the upper right indicate a more restrictive combination of macroeconomic policies.³² From Figure 8 we can see that during the second half of the first Schröder government large and significant expansionary impulses from fiscal and monetary policies were taking place in the U.S. and the U.K. whereas for the entire Euro area in general and for Germany in particular, fiscal and monetary policies were tighter, indeed resembling those of Japan. IMF forecasts of changes in the structural fiscal balance for 2003 compared to 2002 indicate during

the first year of the Gerhard Schröder second term there was still too little help from monetary and fiscal policies to support economic expansion.

<<Insert Figures 8-10 approximately here>>

Fiscal and monetary policies can work together in the same direction or they can work at cross purposes (with respect to stimulating the level of economic activity and reducing unemployment). Unfortunately for the German unemployed, there was not even the trace of a policy mix in which monetary easing by the ECB might have (over-)compensated the missing fiscal stimulus.

In Germany such views are not shared by many or indeed by most leading economists. Sinn (2003) in one of his many *obiter dicta* (p. 99) sprinkled throughout a quite excellent book claims that Germany's employment woes are 85% supply side and only 15% demand side related. While the general point can be easily granted as valid (it is why this point is discussed *after* the discussion of labor market reform), it hardly follows that the German government should feel itself constrained to fighting on the supply side of the labor market alone. Granting the 85:15 split, a reduction of the number of unemployed by some six to seven hundred thousand is hardly peanuts in terms of lost income and output and still worth our attention. In terms of an impact on a close election, a reduction of unemployment of this magnitude might even make the difference between winning and losing.

Independent of the issue of whether Germany should even consider expansionary macroeconomic policies to flank its economic reform agenda is the mundane question of whether Germany irrevocably lost its ability to target macroeconomic policies anyway, once it agreed to surrender its DM for the euro. While monetary policy *for Germany* has indeed been irrevocably lost, Gerhard Schröder has discovered some elbowroom for German fiscal policy. The monetary

policy made by the European Central Bank in Frankfurt still matters for Germany, just as sun and rain matter for farmers.

The U.S. Federal Reserve and the European Central Bank have quite different philosophies of monetary policy as reflected in both their formal charters and in the actual implementation of monetary policy we have witnessed. The ECB sees itself (as it sees all other central banks) as solely capable of stabilizing low inflation rates with everything else being an unwarranted distraction from that task. One of the contributions of the monetarist critique of earlier forms of Keynesian policy activism was to show that gyrations in monetary policy themselves can contribute to economic instability, much as a beginning driver tends to oversteer. The problem comes when this macroeconomic insight becomes exalted to dogma much as when the microeconomic policy presumption of respecting market mechanisms is raised to a doctrine of pure *laissez-faire*. Thus we have Germany riding in a monetary boat that may only be rocked for the purpose of inflation stabilization—and then only gradually³³.

The Greenspan Fed is actually pretty typical for the postwar Fed with an understanding of itself having a mandate to support the health of the economy in a broad sense and not being limited to a goal of a particular low rate of inflation. While illusions of having a capacity for fine-tuning the macroeconomy have been long-destroyed by the valid core of the monetarist critique, there nonetheless remains in the Board of Governors of the Federal Reserve an American “ruleless” pragmatism.

These philosophical and institutional differences can be easily seen in Figure 9 that compares the history of the very short-term interest rates that these two central banks are able to set or control quite precisely. What is positively striking is the *timing*, the *size* and the *swiftness* of the interest rate cuts engineered by the Greenspan Fed during 2001 to offset a weakening in the real economy feared to follow the bursting of the stock market bubble in the previous year. We

see that the Fed struck almost a *half year* before the ECB began to reverse its previous interest rate increases. Within a single year (2001) the Fed brought down the Federal Funds rate about *twice* as far as the ECB was to reduce its refinancing rate in *two years*, once it began to bring European interest rates down.

For the Schröder government it is abundantly clear that the dance between European monetary and fiscal partners will continue to be one in which the ECB leads, even dancing to a different tune. If Gerhard Schröder and other euro area leaders involved in the reform of their labor markets and social welfare systems seek a way to stimulate aggregate demand, then their best bet is to be found in reforming, reinterpreting or simply defying the current restrictions of the Growth and Stability Pact.

Before examining the adverse impact of the strict interpretation and enforcement of the deficit and debt criteria of the Growth and Stability Pact, we need to remind ourselves of the legitimate intention behind having a stability pact at all that puts constraints on the acceptable sizes of public budget deficits and debt levels of the member countries of the Euro Area. Episodes of high and explosive inflation are historically the result of a collapse in a government's capacity to cover its current expenses through taxation or borrowing combined with a breach in the bulkhead between fiscal and monetary policy. In its crudest and most obvious form this involves the use of the printing press to pay for current government expenditure—the link between wheelbarrows full of fresh cash and accelerating inflation is not difficult to understand by that point. Essentially the same thing can go on when government debt levels become so high that the interest on the debt plus other kinds of government expenditure come to exceed the tax system's capacity to generate real tax revenue and the finance ministry's capacity to borrow.³⁴ In such a situation, pressure grows for the central bank to “monetize” the new debt, i.e. create new money through the act of buying the government bonds that no one else wants to buy.

Independent central banks do not have to do this, but even proudly independent central banks are themselves only the creation of a political system that under sufficiently extreme circumstances could rescind that independence. Thus the idea behind the Growth and Stabilization Pact criteria—government deficits in a year are not to exceed the value of 3% of the value of gross domestic product, and the national debt shall not exceed 60% of the value of the gross domestic product³⁵—is to provide a credible bulkhead against such future fiscal pressure that might ever threaten the independence of the European Central Bank. One is hardly surprised that people who fear the scourge of high inflation more than the misery of high unemployment would want to set such thresholds “on the safe side” rather than risk being sorry at the loss of monetary policy independence of the ECB.

The practical problem in the use and implementation of the deficit and debt criterion is that the legal and administrative mind seeks to impose thresholds where the economist sees a relatively smooth continuum. Civilization as we know it will not end should the Euro area have average deficits greater than 3% of GDP and/or average national debts greater than 60% of GDP for an extended period. The irony of course is that it was Germany that had insisted upon such membership criteria for joining the euro and as a condition of membership in the euro area. Thus there is a certain justice in the present situation of Germany sharing the stocks with fellow offender France (see Figure 10).

The trouble comes when one tries to implement these criteria in the short-run. The deficit criterion in the Growth and Stability Pact is expressed in terms of actual deficits so that an economy falling into a recession will see its deficit naturally begin to increase as tax revenues fall and government transfers for the poor and unemployed can be expected to increase when times get tough. Should the economy cross below the deficit line as have France and Germany in Figure 10, the terms of the Growth and Stability Pact demand that fiscal belts be tied tighter

which is a *pro-cyclical* fiscal policy rule³⁶. Thus a strict literal interpretation of the Growth and Stability Pact demands that the fiscal authorities of member countries of the euro area kick their economies when they are down. While this may sound too foolish to be true, it is too true.

Fortunately in this case it just might turn out that the worst implications of the stability pact are offset by a countervailing tendency for bad laws to become as laxly enforced. The fact that Germany and France together have been walking on the wild side of the deficit criterion for several consecutive years has made it likely that a somewhat looser interpretation of the Stability and Growth Pact has been established as a precedent, i.e. that countries will have considerably more time to get their fiscal affairs in order consistent with the intent of the pact rather than being forced to step hard on the fiscal brakes just to achieve one of the criteria within a few years.

Gerhard Schröder has shown less than an overwhelming commitment to the timely satisfaction of the stability pact criteria, which has given critics inside his coalition as well as in the opposition an apparent fiscal failure to harp on. Here Schröder's pragmatism works out to Germany's benefit in avoiding an unnecessary tightening of an already tight fiscal straitjacket.

Germany's "transgressions" against these criteria have been met with surprising understanding by the European Commission that believes them to be in large part merely a manifestation of the economic aftershocks from German unification rather than evidence of a member state about to undermine confidence in the euro. Nonetheless, the letter of the Stability and Growth Pact being what it is, these concessions represent little more than a stay of execution for German public budgets.

Hopeless Cause or Cause to Hope?

Gerhard Schröder's second term has surprised many both inside and outside of his party with its active economic reform agenda. Given the length of time it has taken Germany to get itself into a hole of high unemployment, low growth, and unsustainable systems of social insurance, it will take a lucky series of reform chancellors to get the German economy back running with the global leaders again. Theoretically, it only takes one chancellor to mark the change in course and this could be Gerhard Schröder's opportunity to be remembered as more than the spoiler of the Kohl era. At the danger of oversimplification but in the interest of brevity, all possibilities about the near future of economic reform in the German economy can be consigned to one of two scenarios. To end on the happier note, we begin with the pessimistic scenario first.

Scenario I. Too slow, too little, too late³⁷

One only need be reminded about the never ending drama of getting German shopping hours to correspond to the life rhythms of modern German households to realize just how long institutions such as unions, churches and associations of mom-and-pop stores can put up fanatic resistance to even the most obvious and simple reform. Gerhard Schröder has had to overcome parliamentary barricades erected by the ideological street fighters of his own party at every fork in the reform road. With his parliamentary majority threatened more than once in 2003, Schröder has felt himself compelled to repeatedly play the threat-of-stepping-down card which tends to lose credibility with use.

The critical concession wrung out of the Hartz IV proposals by Schröder's intraparty opposition was the establishment of de facto minimum wages for the Unemployment Assistance II recipients placed into local jobs by the new Federal Labor Service. The

qualification “at prevailing local wages” was added to the characterization of jobs that the unemployed must be willing to accept under penalty of benefit loss for placement refusal. The purpose of this qualification is to shield the wages of those employed from downward pressure due to wage competition from the unemployed. Unfortunately it is precisely wage flexibility for those hard-to-place cases that is required to get the long-term unemployed back into jobs.

Counter to a recommendation of the Rürup Commission, one that was fully supported by the Minister for Health and Social Affairs Ulla Schmidt, Gerhard Schröder tabled the gradual future increases in the normal pensionable age from 65 to 67. While such a decision can and most certainly will be reversed in time (the demographic problem is not about to leave us), it is a bad portent when such a modest reform proposal suffers the fate of an unlucky trial balloon.

Once one begins to contemplate the inherent technical difficulties in any major health-care reform—difficulties that are further compounded by the competing interests of health care providers, the institutions that administer public and private health insurance, and the pharmaceutical industry, it is easy to see how the Rürup Commission was unable to come up with a clear majority recommendation. Reforms to date do nothing more than shift entire blocks of health benefits out of the public health insurance system (e.g. crowns, bridges and dentures) and add minor co-payments (the 10 euro quarterly office visit fee) cut costs or enhance revenues of the system without addressing the underlying problems that will continue to drive contribution rates up over the coming decades.

Finally the same facts of demography that endanger the workings of the unfunded systems of social insurance are working against reform. As the relative weight of the population continues to shift to those in or nearing the retirement phase of the life cycle, the natural

constituency for defending existing pension, health, and long-term care entitlements at the expense of long-term sustainability is growing. Elected politicians tend to see reform windows opening sporadically whenever there happens to be a year between major national or regional elections. However it could be the case that further delay might just result in the relevant window of reform freezing shut for a generation.

Scenario II. Reform snowball and a little dumb luck

In this scenario one can imagine that significant social policy thresholds have been crossed during 2003 that will make future reform easier. One such threshold was the decision to suspend pension increases in 2004 in order to maintain pension contribution rates. In the pay-as-you-go system, the decision has traditionally gone in the direction of adjusting contribution rates upwards to pay for mandated increases in retirement benefits. Now the political precedent has been established that the balance between inflows and outflows into the public pension system can take place through adjustments on the benefits side as well. Another threshold is seen in the decision to shorten the duration of normal unemployment benefits and to reduce the subsequent means-tested unemployment assistance benefits to the level of public assistance. This constitutes a major toughening of incentives for unemployed to accept job placements.

Quite independent of Schröder's reform agenda was the threshold crossed in the summer of 2003 represented by the failure of the IG Metall strike in East Germany to force the introduction of a 35 hour workweek in the new states. Add to this the continuous loss of membership in unions across Germany, the retreat of the German unions in the face of major legislative defeats could even become a rout down the line with their once

considerable capacity to block labor market and social reform legislation reduced to just one among many organized interests in German political life.

The missing ingredient for the optimistic scenario of an acceleration of German economic growth that would draw down the stock of unemployed which in turn would help to generate an increased capacity to bear the coming demographic burdens is...good fortune. A booming world economy that increases its demand for goods and services "Made in Germany" matters now as much as ever.³⁸ If this were to occur together with an unexpected surge in German productivity analogous to that which the US economy experienced during the 1990s, then one could even imagine investment in Germany becoming a money making proposition again. Furthermore this would work to improve the fiscal indicators of the Growth and Stability Pact that could forestall needed contractionary fiscal policies to bring Germany back into compliance.

The optimistic scenario seems farfetched following an entire generation of subpar economic performance for Germany. But the fundamental weakness of the pessimistic scenario is that it sells the young generation of Germans short. There is a widespread awareness among young Germans of the nature and the extent of existing generational imbalances and of the poor economic performance of the German economy. The success of the Schröder reform agenda will depend upon the articulation of a vision that there is more to his reforms than the mere slash-and-burn of social protection and entitlements. Gerhard Schröder will have more than enough elections between now and the Bundestag elections of 2006 to work on the articulation of his vision.

Figure 1. Unemployment in Germany
(thousands)

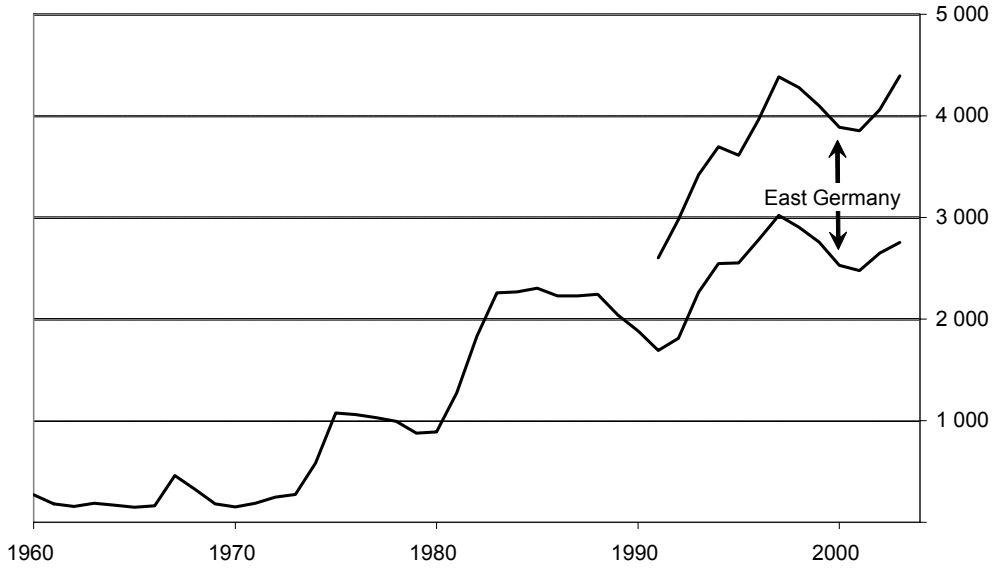


Figure 2. Real GDP Growth in the EU-15, Japan and U.S.
(1991-2004)

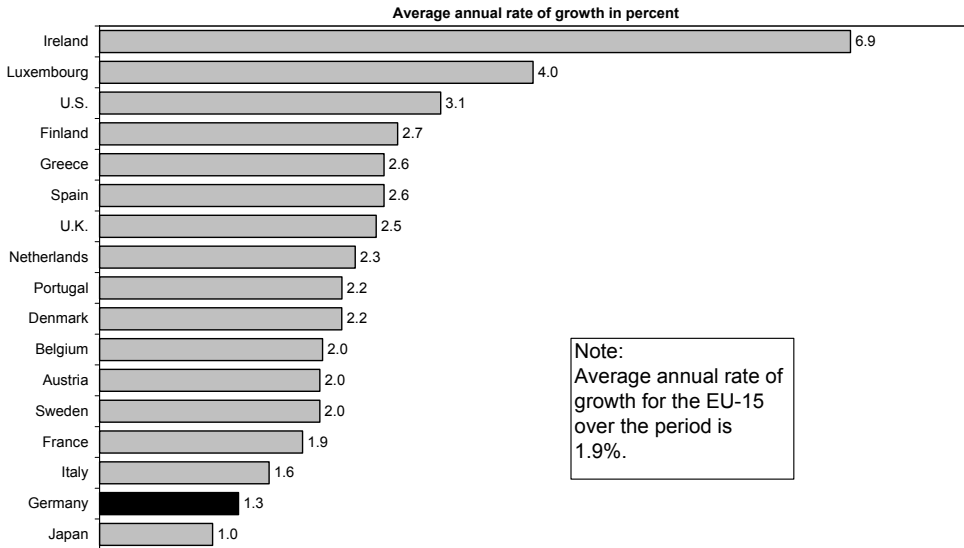


Figure 3. Junior and Senior Citizen Ratios
(relative to population 20-64 years)

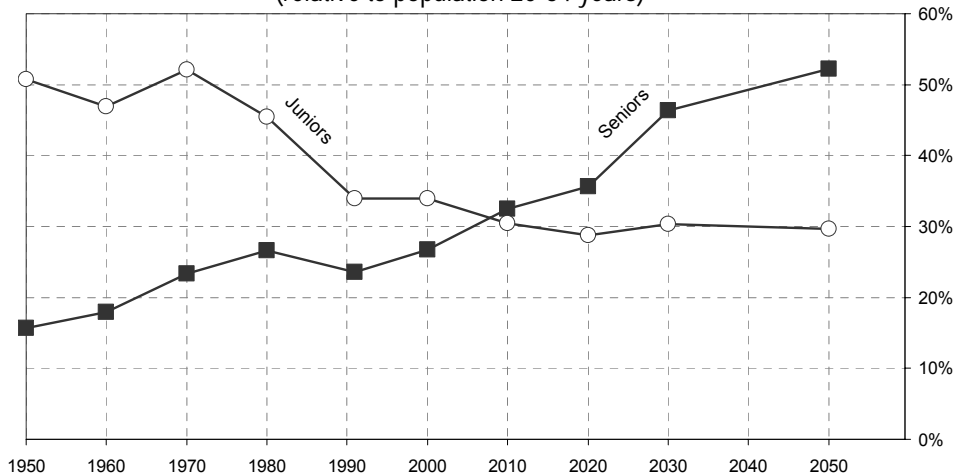


Figure 4. Social Insurance Rates in Germany
(1970-2003)

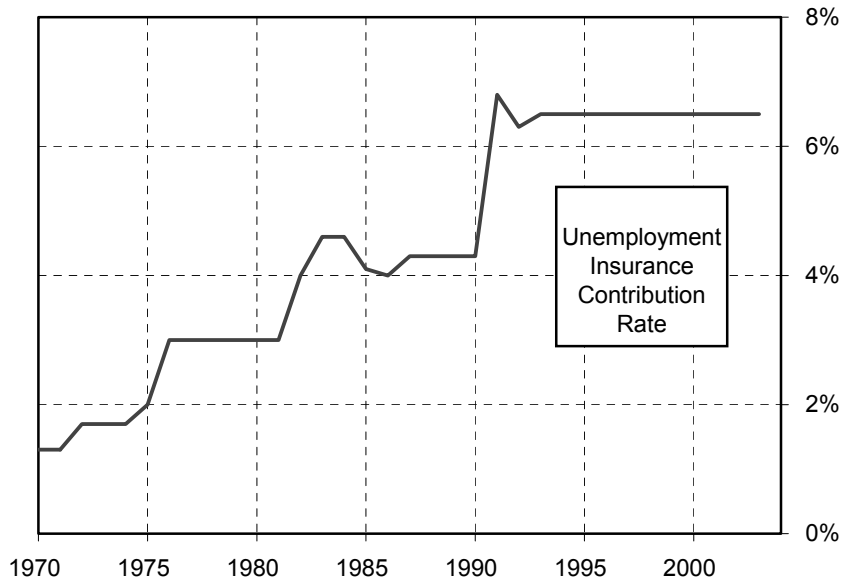
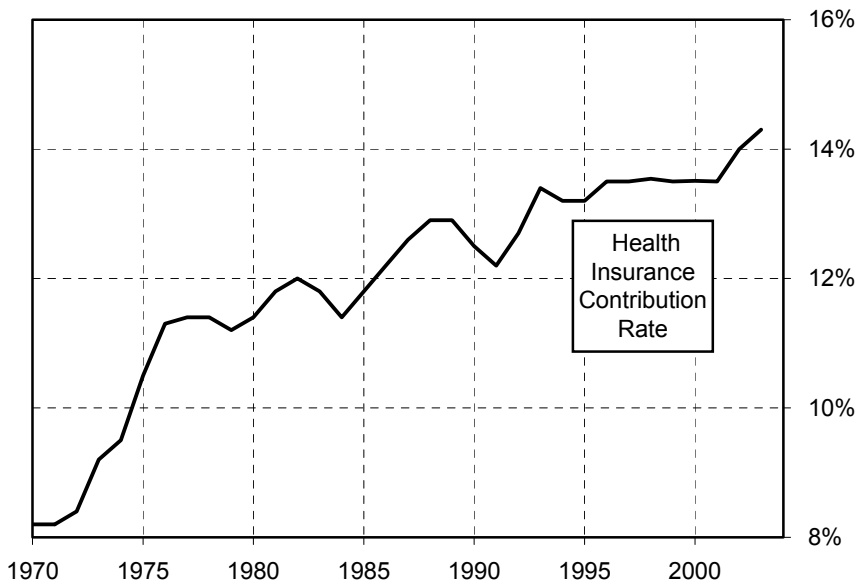
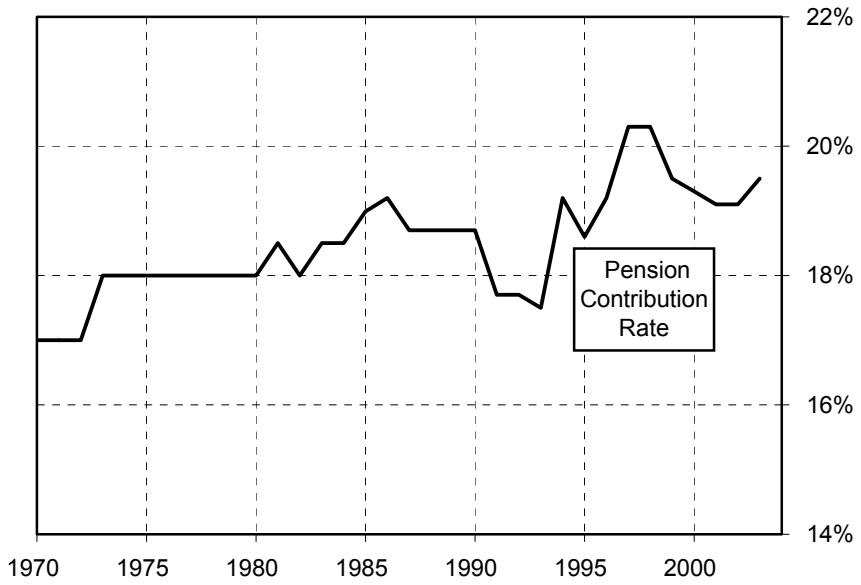


Figure 5. Hourly Labor Costs in Manufacturing
W. Germany, France and the U.S.

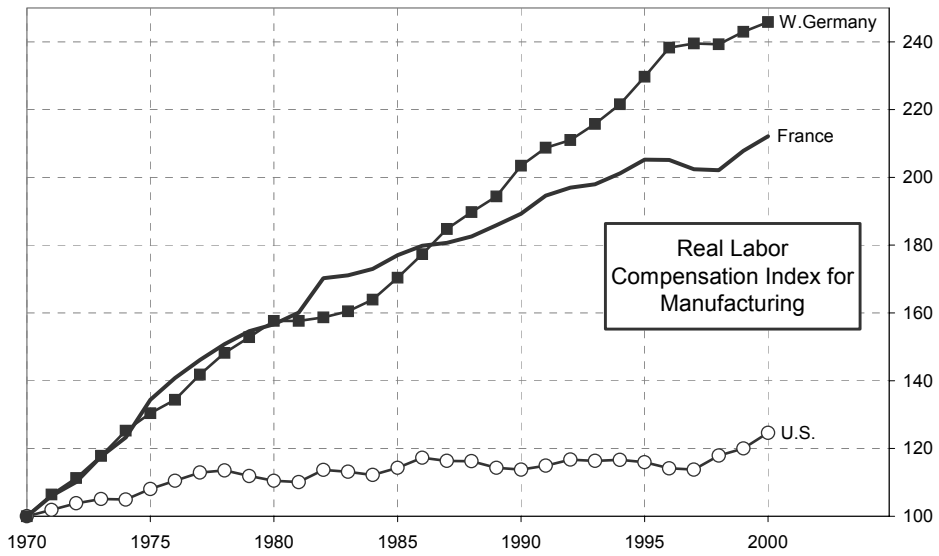


Figure 6. Aggregate Hours in Manufacturing
W. Germany, France and the U.S.

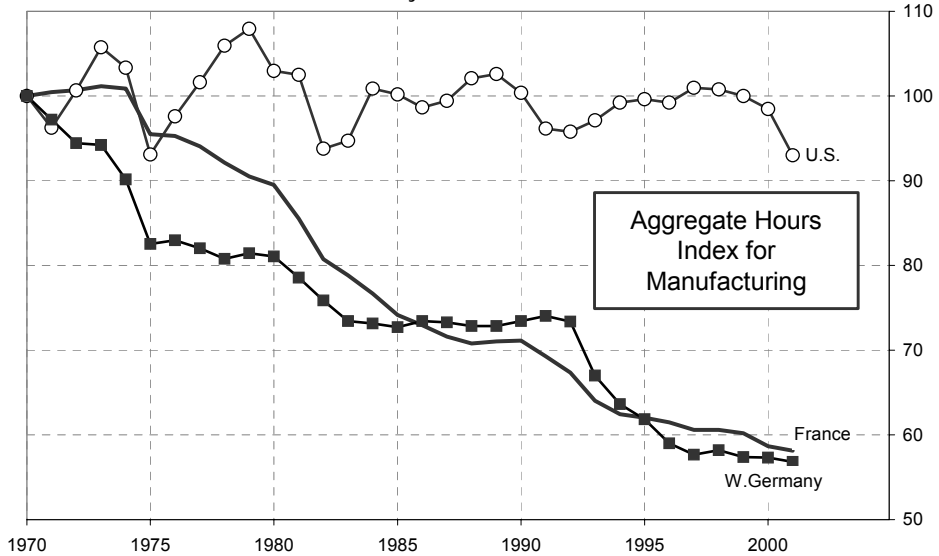


Figure 7. Beveridge Curve in Germany
(1976-2002)

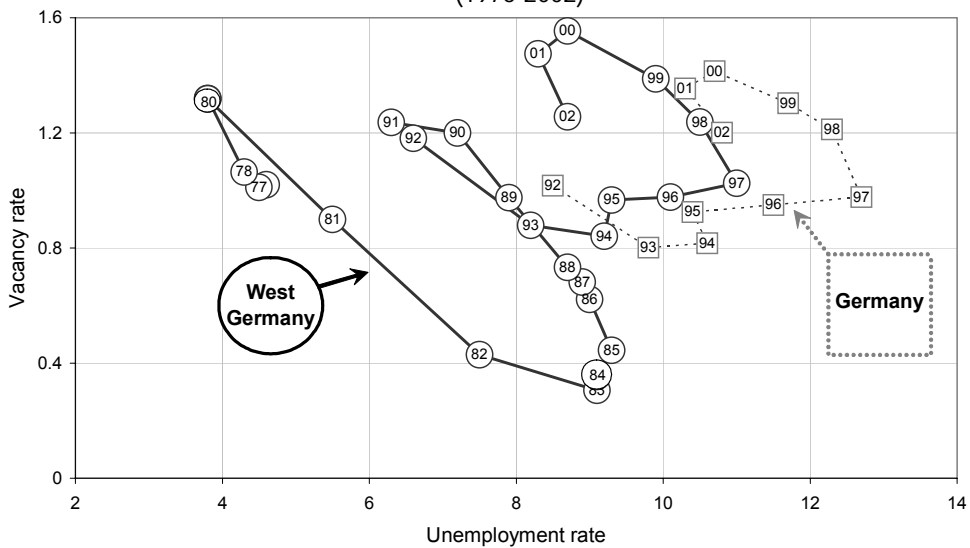


Figure 8. Fiscal and Monetary Policy Changes, 2000-2002

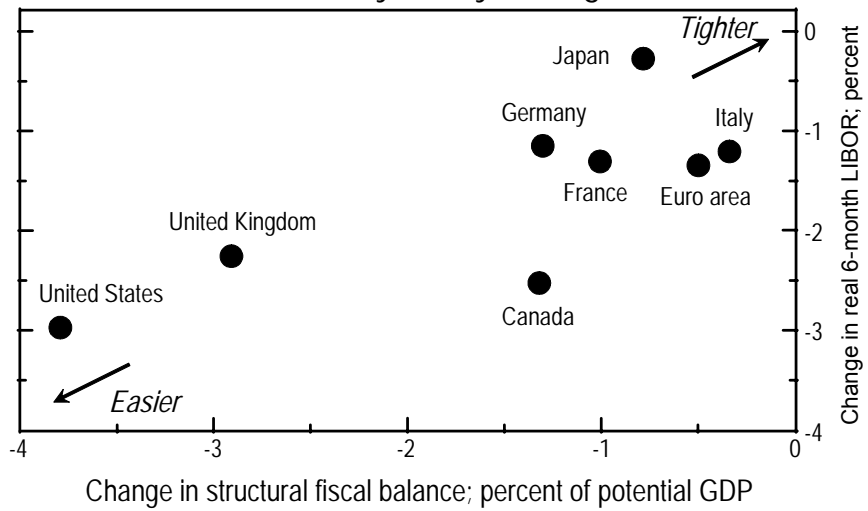


Figure 9. Very Short-Term Interest Rates: the Fed vs. the ECB

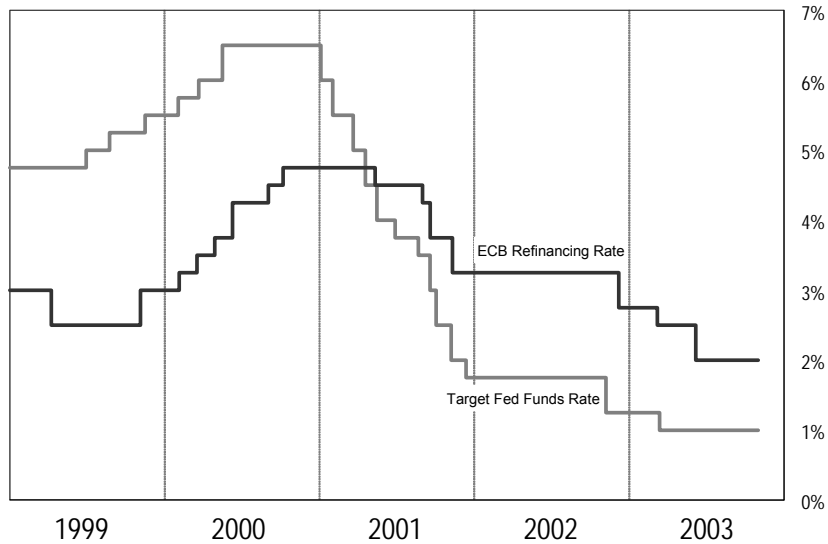
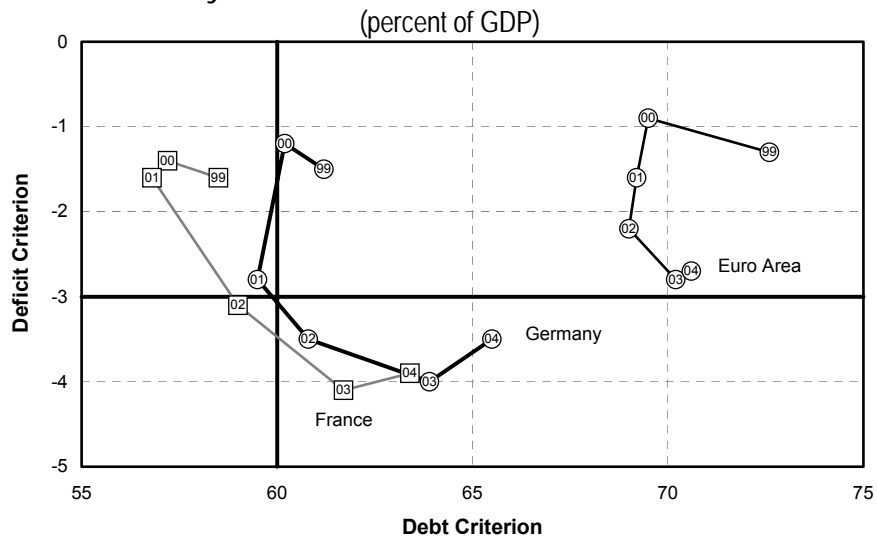


Figure 10. Fiscal Criteria of the Growth and Stabilization Pact
Germany, France and the Euro-Area, 1999-2004



Sources and notes to Figures.

Figure 1. Unemployment in Germany

Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, *Jahresgutachten 2002/03: Zwanzig Punkte für Beschäftigung und Wachstum*. Table 2*. The international and national tables are downloadable as Excel files at [http://www.sachverstaendigenrat-wirtschaft.de/gutacht/02_anhe.zip]

The unemployment data were updated using data from the Herbstgutachten der wirtschaftswissenschaftlichen Forschungsinstitute, published in *DIW Wochenbericht* 43/2003. [<http://www.diw.de/deutsch/publikationen/wochenberichte/docs/03-43.pdf>]

Unemployment data through 1990 were calculated according to existing German definitions of unemployment, beginning in 1991 the numbers were calculated according to the harmonized EU definition of unemployment.

Figure 2. Real GDP Growth in the EU-15, Japan and U.S.

Author's calculations using data from:

Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, *Jahresgutachten 2002/03*, Table 3*.

Updated using forecasts from Arbeitskreis Konjunktur, Grundlinien der Wirtschaftsentwicklung 2003/2004. *DIW Wochenbericht* 1-2/2003, [<http://www.diw.de/deutsch/publikationen/wochenberichte/docs/03-01.pdf>]

Figure 3. Junior and Senior Citizen Ratios

Calculated from data in the ninth coordinated population forecast (Variant 2) as published in Table 14 of Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung *Jahresgutachten 2002/03*.

Figure 4. Social Insurance Rates in Germany

Contribution rates for the statutory pension system, public health insurance system and unemployment insurance system from Tables 69*, 75*, and 78*, respectively, of Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung *Jahresgutachten 2002/03*.

Current values for the parameters of the social insurance systems are available at [http://www.sozialpolitik-aktuell.de/neuregelungen_rechengroessen.shtml]

Figures 5 and 6. Hourly Labor Costs and Aggregate Hours in Manufacturing

Source of comparable data on aggregate manufacturing hours and hourly compensation index:

U.S. Department of Labor, Bureau of Labor Statistics, Foreign Labor Statistics Program.
[<http://www.bls.gov/fls/home.htm>]

Figure 7. Beveridge Curve in Germany

Data Source: Federal Labor Office (Bundesanstalt für Arbeit)

Stock of job vacancies (Bestand an gemeldeten Stellen)
[http://www.pub.arbeitsamt.de/hst/services/statistik/aktuell/iiia4/zr_stellen_ab_1976b.xls]

Unemployment rates (Registrierte Arbeitslose)
[http://www.pub.arbeitsamt.de/hst/services/statistik/aktuell/iiia4/zr_alo_qu_west_ostb.xls]

The vacancy rate was obtained by dividing the published stock of job vacancies by the number of non-self-employed workforce (abhängige Erwerbspersonen). The non-self-employed workforce is the denominator for the unemployment rate. Thus the non-self-employed workforce for the vacancy rate was calculated by dividing the published unemployment rate into the number of registered employed in the table cited above.

Figure 8 Fiscal and Monetary Policy Changes, 2000-2002

Source: International Monetary Fund,
World Economic Report. September 2003, p. 5.
[<http://www.imf.org/external/pubs/ft/weo/2003/02/index.htm>]

Explanation: Because tax revenues rise and fall with the ups and downs of the business cycle whereas transfer payments from the government to individuals move in the opposite direction, changes in government budget deficits that we actually observe can confound changes in the underlying fiscal policies with changes in the fiscal balances induced by changes in the level of economic activity. Thus economists attempt to gauge the direction of changes in fiscal policy by estimating the magnitude of changes in government budget balance were the economy at its potential output and such fiscal policy changes had been undertaken.

The *structural fiscal balance* is expressed as a percent of potential GDP to adjust for the underlying trend rate of economic growth that would cause the absolute size of the structural fiscal deficit or surplus to change without any change in the fiscal policies themselves. A movement to the left in Figure 8 means a net expansionary fiscal impulse has been given to aggregate demand through tax reductions and/or increases in government spending (either on goods and services or on income transfers). Points to the right in the figure indicate less expansionary or even contractionary changes in fiscal policies.

Along the vertical axis of Figure 8 we can see the change in the real six-month London Interbank Offer Rate (LIBOR). This is an average of the interest rates that major international banks charge each other to borrow U.S. dollars in the London money market and it responds quickly to the changes in the very-short term interest rates that central banks are able to determine.

Figure 9. Very Short-Term Interest Rates: The Fed vs. the ECB

Data Sources:

Board of Governors, U.S. Federal Reserve. Targeted federal fund rate.
[<http://www.federalreserve.gov/fomc/fundsrate.htm>]

European Central Bank. Rates are reported for fixed rate tenders through June 2000, after which time the minimum bid for variable rate tenders is reported.
[<http://www.ecb.de/home/ecbinterestrates.htm>]

Figure 10. Fiscal Indicators of the Growth and Stability Pact

Herbstgutachten der wirtschaftswissenschaftlichen Forschungsinstitute, published in *DIW Wochenbericht* 43/2003. Table 2.1.
[<http://www.diw.de/deutsch/publikationen/wochenberichte/docs/03-43.pdf>]

Arbeitskreis Konjunktur, Grundlinien der Wirtschaftsentwicklung 2003/2004. *DIW Wochenbericht* 1-2/2003, Table 2.3
[<http://www.diw.de/deutsch/publikationen/wochenberichte/docs/03-01.pdf>]

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- ¹ Research for this chapter was conducted during the author's visiting professorship at the Graduate School of Public Administration (GSPA) of Seoul National University, Korea during the academic year 2002/2003. An early version of the chapter was presented in a faculty seminar at the GSPA. I most gratefully acknowledge the outstanding conditions for teaching and research provided to me at SNU, in particular the time and efforts of Dean Yeon-Cheon Oh and his colleagues to integrate me into their community of scholars.
- ² English language materials concerning the Programme for International Student Assessment can be found at the Max-Planck Institute for Education in Berlin. <http://www.mpib-berlin.mpg.de/pisa/english.html>
- ³ Sinn, Hans-Werner (2002). Die rote Laterne—Die Gründe für Deutschlands Wachstumsschwäche und die notwendigen Reformen. *ifo Schnelldienst* 55/23, 3-32. Cf. The first chapter, "Schlusslicht Deutschland," in Professor Sinn's recently published book *Ist Deutschland noch zu retten?* Econ Verlag, 2003.
- ⁴ See the forecasts published in the annual Fall Economic Report of the Arbeitsgemeinschaft deutscher wirtschaftswissenschaftlicher Forschungsinstitute, "Die Lage der Weltwirtschaft und der deutschen Wirtschaft im Herbst 2003" in DIW, *Wochenbericht* Nr. 43 (October 23, 2003).
- ⁵ An analogy with the "marriage market" can help illustrate the point. Can we explain the observed variance among people in the length of time spent in finding their mates? Dating is part of the search process for a match made in heaven. How long this search process goes on will depend upon supply considerations (how high are someone's standards?) and demand considerations (what is the demand for someone with such characteristics?).
- ⁶ Only three countries have been chosen to keep this diagram uncluttered. It is not difficult to see the same pattern with other countries.
- ⁷ There is another way to read Table 1. It provides us with an international comparison of the temptation to avoid taxes and social insurance contributions by not reporting income for additional work. With two-thirds of the bill for labor services to split between a service provider and a customer in Germany, it is not too difficult to imagine a cash agreement on terms acceptable to both parties. The Schröder government will introduce stronger criminal sanctions for tax and social contribution evasion to go into effect in 2004 (including maximum prison sentences of 5-10 years). Poorly designed tax systems and draconian enforcement mechanisms undermine the legitimacy of any government's attempt to collect revenues for the public purpose.
- ⁸ One instinctively objects that workers are taxed more in such countries than in the U.S., but they get more public service and greater social security. The point here is that from the perspective of the individual provider of labor services, the level of public provision of service and social security is perceived as given and more-or-less independent of the taxes and contributions assessed on additional income of that individual. The choice for the housepainter in Germany is not "Do you want to work in Germany or the U.S.?" The choice is whether to work

less, work more and pay to Caesar what is Caesar's, or work more without telling Caesar. Whatever the housepainter chooses, he/she does not believe it will make much of a difference for the level of the family's health coverage, the ultimate pension entitlement, or even the quality of city services.

⁹ The reader is warned that it is something of a stretch to claim that a rough balance in the aggregate numbers of vacant jobs and unemployed people is a particularly meaningful way of operationalizing the notion of full-employment.

¹⁰ E.g. the threshold for the laws on employment protection were tightened to apply to businesses with more than five employees instead of more than ten employees; employees' sick pay was increased back from 80% to 100% of regular pay.

¹¹ The Arbeitnehmerkammer Bremen provides an excellent collection of materials (in German) on all aspects of German labor and social policy at their website: <http://www.arbeitnehmerkammer.de/sozialpolitik/index.html>

Its archives include complete versions of both the Hartz and Rürup Commission reports and vast quantities of background materials and documents regarding the nuts-and-bolts of the Agenda 2010 proposals discussed in this chapter. Most of the commentary comes from union sources with a definite leftist slant, so that the website also provides a convenient opportunity to monitor developments on Gerhard Schröder's "left-ern front".

¹² This is a serious charge. An illustration from the Commission's final report: "The new service quality finds its expression in the architecture and the interior design of the JobCenter. These give the 'Employment Office' a new face. The image of a corridor lined with the unemployed standing before closed doors and waiting for their 'case' to be processed will be replaced by one of an open architectural space with diverse offerings of information, events and things to do (e.g. Job-Ticker, Info-Terminals, occupational information centers, Internet-Bar, Café/Bistro, space for exhibitions)." (p. 75). Just as wonderful bicycle paths constructed in the new states have not led to blossoming landscapes in the East, so too it is unlikely that a cappuccino to die for at a JobCenter Café will do anything more than increase the quality of unemployed life.

¹³ As if to prove that high employment is an Anglo-American creation, but almost certainly only the reflection of the dominance of American management consultant gurus in the business, everything in the Hartz Commission recommendations appears to have been rechristened with nice English names. The *Arbeitsamt* becomes the JobCenter (pronounced "tschop-tsintah", so this does not sound nearly as foreign to German ears as one might think), the BridgeSystem for the older unemployed replaces an *Überbrückung* (a saving of two umlauts!), PersonalServiceAgenturen, JobFloater, etc.

¹⁴ One example described in a recent radio broadcast was of an unemployed woman in Brandenburg who with her husband formed an *Ich-AG* that provided mobile poodle-clipping service traveling from village to village. Loans were arranged that allowed her and her husband to purchase a van and the necessary equipment.

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- ¹⁵ When the Minister for Economics and Labor, Wolfgang Clement, recently suggested that it is entirely suitable for an unemployed professor to sell sausages on the street, he was greeted with a howl of indignation at the implication that basically all work was suitable for all people who were without work. In Germany it constitutes something of a revolution when the burden of proof of the suitability or unsuitability of a job is shifted from the employment office to an unemployed person offered a job. Happy is the land that cannot empathize with the notion of *Zumutbarkeit* in this context.
- ¹⁶ This political horse-trade between coalition partners was reported in *Die Welt* March 28, 2003.
- ¹⁷ Only one month earlier in a major reshuffling of ministerial portfolios, the former Ministry for Labor and Social Affairs had been split between the former Ministries of Economics and Health. Wolfgang Clement, former premier of North-Rhein-Westfalia, joined the Schröder government as a Superminister in charge of economic affairs and employment. Ulla Schmidt's ministerial domain expanded from health to include all the major systems of social insurance with the exception of unemployment insurance.
- ¹⁸ One sees that the Rürup Commission was an awkward fit for the Agenda 2010 timetable from the beginning. Serious reform legislation needed to be in the parliamentary pipeline by mid-summer 2003 to escape being held up later due to tactical considerations related to the timing of elections in 2004. The deadline for recommendations from the Commission was moved forward to June, then March, then back to the end of April so they could be fed into preparations for the June 1 Berlin party conference of the SPD. The actual final report was turned at the end of August.
- ¹⁹ Chairman Rürup himself had been sensitized by public criticism from the interim SPD fraction leader in the Bundestag, Ludwig Stiegler: "I am fed up that we have to put on a brave face for the membership and the voters each time the Professors start to chatter." Stiegler went on to criticize what he considered premature utterances made by Rürup on pension reform before his Commission was even constituted. *Die Welt*, December 5, 2002.
- ²⁰ With the following difference: the 2030 "standard pensioner" will have worked 1.7 years longer before retirement (and through the blessing of late birth, expects to have as many years in retirement as someone retiring younger in 2003). The pension will be almost 50% higher in real terms than it is today as well.
- ²¹ Think of a university that grants financial aid to students. One way to provide aid is to grant scholarships based on need and the other is to charge needy students less for room and board and offer them lower prices for books. The former system is administratively simpler, easier to target to the particular circumstances of the individual students and essentially leaves it to the students themselves to decide on which combinations of dorm rooms, meal plans and books give the most value for the money. The point is that it is quite possible to correct a bad income distribution without making everything depend upon on a differential treatment of those with high and low incomes.

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- ²² An English version of the SPD party conference resolution “Courage to reform” can be downloaded from the English language pages at the official SPD website: <http://www.spd.de>
- ²³ To protect existing unemployment benefit entitlements, these new duration limits will only become completely effective 32 months once the new rules go into effect.
- ²⁴ E.g. Wissenschaftliche Beirat beim Bundesministerium für Wirtschaft und Technologie. *Reform des Sozialstaats für mehr Beschäftigung im Bereich gering qualifizierter Arbeit*. July 23, 2002.
- ²⁵ “Employment protection” is partially misleading since it glosses over the additional labor costs introduced through the resulting greater inflexibility in changing a business’s workforce which tends to make new employment less rather than more likely should business improvements otherwise warrant an expansion in capacity.
- ²⁶ Details can be found in the guidelines for the program: SPALAR (Sonderprogramm-Arbeit für Langzeitarbeitslose-Richtlinie). <http://www.arbeitsamt.de/hst/services/afl/afl03.pdf>
- ²⁷ Interview in *Leipziger Volkszeitung*, November 9, 2003.
- ²⁸ Critics claim that an increase in the effective retirement age is not expected to have much of an impact because people who choose early retirement under present rules are accepting reduced pensions so that the value of lifetime benefits for early retirees do not really change significantly and are only spread over a longer period of life.
- ²⁹ Electricians and opticians are still subject to the mandatory certification process for instance.
- ³⁰ For the economic reconstruction of postwall East Germany however, European monetary union turns out to have been one of a long list of bad policy choices. This is argued in Irwin Collier, “The Twin Curse of the Goddess Europa and the Economic Reconstruction of Eastern Germany,” *German Studies Review*, October 1997, 399-428.
- ³¹ Cf. Charles Wyplosz, “The Stability and Growth Pact: Time to Rethink”. Briefing Notes to the Committee for Economic and Monetary Affairs of the European Parliament (Dec. 2002). http://www.europarl.eu.int/comparl/econ/pdf/emu/speeches/20021203/20021203_wyplosz.pdf
- ³² This diagram is explained more fully in the chapter appendix “Notes to the Figures”.
- ³³ There is another important difference between the two institutions. In the world of central banking reputation is a critical aspect that affects the impact of monetary policies. The European Central Bank, while being a direct descendent of the German Bundesbank (or at least bearing a strongest family resemblance), is still a fledgling institution in the history of monetary affairs. Its relatively small steps are due in at least some part to an

understandable caution regarding its own future long-term reputation. It deathly fears establishing a reputation of being too easy in ratifying inflationary impulses.

³⁴ Rational investors recognize the unsustainability of lending money to someone to pay the interest on what they have borrowed from someone else and demand increasingly larger interest rates to compensate them for the risk of default. The rise in interest rates makes the next round of borrowing even more difficult. Every Ponzi chain-letter type scheme runs out of suckers.

³⁵ The 3% and 60% figures were not pulled out of the air and are usually defended using the following argument. Governments are observed on average in the EU area to spend roughly 3% of GDP on public investment, so that the 3% deficits are not a danger for stability because the benefits of the public investment will be spread into the future as will be payments for that investment. Next assume that nominal GDP will grow 5% a year in the future (part of the growth is real and part is inflation but that is not important). Suppose that GDP this year is 100, national debt is 60 and the deficit is 3. Next year GDP will be 105 and debt will grow to 63 which is 60% of 105. Hence the 60% debt criterion is consistent with a 3% criterion for deficits and a growth rate of nominal GDP of 5%.

³⁶ The same fundamental criticism is made of rigid balanced-budget amendments by macroeconomists which amount to constraining fiscal authorities to conduct a destabilizing fiscal policy.

³⁷“We Germans do not believe in big bangs.” Quotation attributed to an unnamed close adviser to Gerhard Schröder. *Economist* Dec. 5, 2002.

³⁸ The extraordinary third quarter 2003 surge in the U.S. economy can be offered as evidence that expansionary monetary and fiscal policies do indeed make a difference and that Germany probably owes the Chairman of the U.S. Federal Reserve Board, Allan Greenspan, a *Bundesverdienstkreuz*.