Challenges for the German Welfare State before and after the Global Financial Crisis

Mark Hallerberg

Germany has a northern European welfare state. This means that social benefits are extensive compared not only to the American standards but compared to other European countries, such as Italy or Spain. In the early 2000s, both foreign observers and Germans themselves considered the country the "sick man of Europe." Its firms seemed increasingly uncompetitive, due especially to its costly labor. Economic growth in this period was stagnant. This "exporting giant" even had a slight current account deficit.

A decade later, perceptions of the country changed; it is now perceived as the only economy that can keep Europe afloat during the storm of the euro crisis. Some in southern Europe complain that the Germans were the main beneficiaries of the euro, and they should therefore pay more to ensure the common currency's survival. The main argument behind this assertion is that the German mark entered the euro at an undervalued rate. This argument ignores, however, the reforms that a center-left coalition in particular put in place that made the German economy more competitive. A telling statistic is unit labor costs—while they remained roughly the same from 2001 to 2011 in Germany, average unit labor costs in the eurozone increased 20 percent. Rather than current account deficits, the country runs large current account surpluses. The unemployment

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Mark Hallerberg is Professor of Public Management and Political Economy at the Hertie School of Governance, where he is also the Director of the Fiscal Governance Centre.

rate, which approached 10 percent in 2005, now approaches 5 percent, well below even the United States. What changed during the 2000s set up the country to do well in the period after the global financial crisis? This article reviews Germany's major welfare reforms as well as some reasons why they were put in place. It also covers the period both before and after the global financial crisis, and it concludes with a few thoughts about the challenge of demographic change to the viability of the German welfare state.

Reforming the Welfare State

As Anke Hassel (2010) argues, the transformation of the German welfare state began after reunification in 1990, but it reached its peak with the Hartz IV reforms, which were named after Peter Hartz, the chairman of the commission that considered reform options. Those reforms, in turn, were embedded in Chancellor Gerhard Schröder's Agenda 2010 program. The chancellor had formed a Red-Green alliance composed of the Social Democrats and the Green party after his electoral victory in 1998. The state of the economy was an electoral issue in 2002. His perceived strong, and effective, leadership in the face of widespread floods in the eastern part of the country that summer, as well as his claim that economic troubles were due to problems abroad and not at home (September 11 in particular), meant that his coalition survived what at first looked like a difficult election in September 2002. Schröder had backed an initial set of reforms the Hartz Commission had already recommended before the election, the so-called Hartz I, II, and III reforms, which mostly reformed the administration of unemployment benefits and vocational training.

But the economy did not improve after the election. Economic growth remained essentially at zero in 2003 as well, and the budget deficit crept above the European Union's Stability and Growth Pact limit of 3 percent of GDP, which normally would connote what the Union would label an "excessive deficit." Schröder then proposed the biggest set of reforms to date, Hartz IV. While his coalition held a majority in the lower house, approval required some compromises with the center-right-controlled upper house, the Bundesrat, but the reforms were significant. These reforms were also controversial, and they turned the main labor unions against a Social Democratic chancellor. After a state election loss in the largest state in Germany,

Northrhine-Westfalia, Gerhard Schröder asked for new elections. While the results were certainly closer than anyone foresaw at the time, it is not an exaggeration to write that disillusionment among core Social Democratic voters was one reason why the coalition lost its electoral strength.

The content of these substantial reforms remain, for the most part, in place today, and it is an important reason why German industry became more competitive. First, Hartz IV limited the full payment of unemployment compensation to one year from the previous duration of two years. Up to a cap, the German system paid a percentage of the previous wage, not a flat rate. After this year, the unemployment payment dropped to around 350 euros, with additional supplements possible for rent, heat, and children. If one refused to accept a job, payments were cut a further 30 percent. There were also "1 euro jobs" created, where the state could employ someone at 1 euro an hour who was on benefits. In addition, there was also consideration of one's savings and the salary of one's spouse when calculating these benefits.

Separately in the 2000s, both during Schröder's term as well as after Angela Merkel replaced Schröder as chancellor in a grand coalition of the large parties of the center-right and center-left, the government passed pension reforms. The Riester reforms, begun in 2001, moved the public pension system from a traditional pay-as-you-go system to a more multipillar one, with government subsidies for voluntary private contributions. In 2004, the government linked pension adjustments to the number of contributors and recipients. This step theoretically will mean cuts in the future, assuming no change in policy. Finally, in 2007, the grand coalition agreed to increase the retirement age to 67 by 2029.

A third notable reform came into its own after the global financial crisis, and is known by its German name, *Kurzarbeit*. This was a program where the state paid up to 70 percent of a person's salary up to a given cap, workers took a cut in hours and pay, and firms agreed not to lay off the worker. There were some concerns about misuse under the program, where firms had the government pay for workers they would have kept anyway. There is also a debate in Germany about how many jobs this program really saved during the crisis, with one study suggesting as many as 1.2 million people avoided unemployment. While the real figures are probably much lower, the practical effect of the program was that firms that experienced a big

decline in orders in 2009 due to a worldwide collapse in international trade were able to expand capacity quickly during the rebound in 2010 and 2011.

These reforms, taken together, changed the welfare system of Germany. They alone do not explain Germany's reversal; the private sector also played its part in terms of restructuring and the use of new technology. Nevertheless, these reforms did contribute to a more competitive economy.

Possible Lessons from Germany's Experience

The process for passing such major reforms may be of interest to other countries considering reform. It usually started with the identification of a major problem and the subsequent appointment of a multiparty commission that included members from the private sector. This commission then set the agenda and took a lead role in bargaining between the main parties of the center-left and center-right.

While the German welfare state has changed, it needs to continue to evolve, not just because of continued economic competition with other countries but because of inevitable demographic change. Germany currently has one of the lowest birthrates in the European Union, below 1.4 children per woman, which is nowhere near the replacement rate. It also does not attract many immigrants, nowhere near enough to bridge the gap between the low birthrate and the level of new workers needed to replace those retiring. The German government estimates that the number of working-age people in Germany will decline from 49.5 million to 43 million between 2010 and 2030. Despite a decade of reforms, the system probably is not sustainable over the coming decades if there are no further policy changes. And this comes in the context of a German population where the median voter was 50 years old in the last national elections in 2009. It will become harder, rather than easier, to reform pensions and health care as voters continue to age.

Nevertheless, the relatively generous German welfare state made it through the 2000s in better shape than most of the other European Union member states. One particularity of the euro crisis is that several countries with the larger welfare states—the Scandinavian countries, Germany, and the Netherlands—have done better than other European countries with smaller welfare states. An exception perhaps is France, a generous welfare state where

even current levels of spending do not appear to be sustainable. But an important difference between southern and northern Europe is the funding basis of the respective welfare states. In countries where governments expanded benefits on the back of revenues from property booms, deep cuts in benefits appear to be unavoidable.

Reference

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