GERMAN UNIFICATION AND 'MODEL GERMANY':

AN ADVENTURE OF INSTITUTIONAL CONSERVATISM

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Abstract

Germany today appears to be anything but the fortunate country it was on the eve of unification. The extension of Model Germany to Eastern Germany has contributed to the predicament Model Germany has encountered in the emerging international political economic setting. The pattern of unification and its consequences have impaired the sustainability of the once cherished socio-economic order. Unification has made institutional reform both more urgent and more difficult. If major reform cannot be achieved without an external shock, a redistribution of political jurisdictions in favour of the subnational Länder level could perhaps offer a feasible detour on the way to improved performance.

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INTRODUCTION

At first glance, Germany appears to have benefited extraordinarily from the collapse of East European communism. With the accession of the German Democratic Republic (GDR) to the Federal Republic of Germany (FRG) on 3 October 1990, Germany was able to overcome one painful result of its defeat in World War II: its split into two opposing parts along the front line of the Cold War. Moreover, reunification seemed to promise that West Germany would reinforce its already strong position among the world's leading economies.

But a few years after unification, it became apparent that the event has hurt German economic performance more than it has helped. From 1992 to 2002, Germany experienced growth rates below its annual increases in productivity, resulting in rising unemployment and the weakest economic performance overall among all the European Union countries. While economic reform issues took centre stage in the 1998 and 2002 German federal election campaigns, the Red-Green government achieved little tangible change. This was due in large part to the fact that the unification process had contributed both to the worsening of Germany's economic performance as well as to its political stalemate over economic reform. Failure to adapt to new challenges does not protect the status quo. Rather, it is likely to make the situation more painful.

In the process of unification, the transfer of Western political-economic institutions to post-socialist Eastern Germany took place just at a time when 'Model Germany' was beginning to lose its capacity to deliver favourable economic outcomes, even in the Western heartland. To make matters worse, West German institutions were imposed on a social and economic fabric that lacked the organisational prerequisites to benefit from them. As a consequence, the transfer of institutions to Eastern Germany accelerated the crisis of the German model in the unified country.

My paper addresses two questions. First, how and why did the process of unification negatively affect the nation's ability to sustain the German model? Secondly, why have the problems and detrimental consequences of institutional transfer nevertheless made it harder rather than easier to reform key pillars of the model? This paper will focus first on the macroeconomic dynamics of East Germany's incorporation into the West. These dynamics made it harder for Eastern Germany to create microeconomic institutions and mechanisms like those in West Germany that would be able to sustain economic growth. This is the subject of the second part of the paper. Finally, Eastern German public opinion is opposed to any macro and microeconomic reforms that might get Germany out of its predicament. This leaves few options open for serious reform. I will speculate about this in the conclusion of my paper.

THE MACROECONOMICS OF GERMAN UNIFICATION

West Germany never relied on a counter-cyclical Keynesian fiscal policy, and especially not on demand-side deficit spending during periods of economic recession. The terms of unification, however, forced German economic policy making into precisely that pattern.

Four general conditions shaped – if not over-determined—a post-socialist pathway of political-economic reform in the territory of the former German Democratic Republic that was unlike any chosen by neighbouring post-socialist countries. First, in terms of *international security and power relations,* Western elites perceived a fleeting window of opportunity to seize upon Gorbachev's willingness to trade the GDR in for a new era of cooperation with the West. Asserting a "primacy of politics" over mundane economic details, the Bonn government hurriedly closed a deal with the four World War II allied powers that made rapid unification possible. International security considerations caused the Kohl government to ignore the warnings by leading economists and opposition leaders that the costs of rapid unification would be very high. The speed of unification, in turn, left little room for social experiments and required that existing institutions be transferred to the new German *Länder* that had previously constituted the German Democratic Republic.

Secondly, initial uncertainties about East German support for the rapid absorption of the GDR into West Germany shaped the pathway of unification. In the fall of 1989, neither the East German civil rights associations nor the small group of reformers within the Communist Party that would later refashion itself as the Party of Democratic Socialism (PDS) welcomed a 'capitalist' system. Instead, they preferred a modernised democratic socialist East Germany in an economic and political confederation with West Germany. West German politicians were able to overcome popular East German reservations by embedding unification into the process of deepening European integration. They also offered economic benefits to East Germans that would allow them to rapidly approach the standard of living enjoyed by West Germans. In this process, the memory of West Germany's 'miracle economy' of the 1950s and 1960s served as a helpful myth, even though the preconditions—such as an undervalued currency or a rapidly expanding post-war world economy—were manifestly missing in the early 1990s. The Eastern elites' principled aversion to unification was rendered ineffectual after the unequivocal popular pro-unity vote in the last GDR legislative election on March 18, 1990.

Thirdly, the rapid speed and external, West German control of the unification process came about as a result of the weakness of East German civil society and of nascent post-communist politics after forty years of intense repression – which, since the 1960s, had not allowed dissidents to organise themselves in ways comparable to Hungary, Poland or Slovenia. Although some twenty East German civil action groups and organisations had been founded in the autumn of 1989, they played only a minor role in identifying and representing the citizens' interests. As a consequence, the Bonn government was able to drive forward the process of unification as a transfer of West German institutions with virtually no serious opposition – especially after the March elections had awarded the East German affiliates of the major West German parties an overwhelming majority in both the legislative and executive branches of the GDR government. All aspects of reform – whether in the form of direct institutional adoption, as a consequence of extensive bargaining, or as market-driven change[1] – thus boiled down to the external governance of unification by the West German political and economic elite. However, this could only be made palatable to the East Germans by granting them comprehensive economic benefits and protections from the costs of economic and institutional transformation.

Fourthly, Western electoral and political-economic interests drove the speed of the unification process. Only a high pace of unification would guarantee the governing Christian Democratic-Liberal coalition government the opportunity to time the all-German elections sufficiently early to take advantage of the initial popular enthusiasm and optimism before its costs and frictions could surface and lead to disenchantment.

Against the backdrop of these conditions, the implementation of pluralist democracy and a market economy in East Germany and the legal unification of the country occurred within the span of less than one year. Economic, Monetary and Social Union (EMSU) already took effect in July 1990. This secured the transfer of West Germany's entire array of legal, social and economic institutions and became the framework for all subsequent regulations – in particular, the Treaty of Unity, which resulted in the GDR's formal accession to the Federal Republic of Germany.

Thus, from the very start, Eastern Germany benefited from a proven and complete institutional system that included a legal framework, a judicial system, administrative agencies and representational bodies. Neither the political institutions of the market economy, the demarcation of sub-national administrative jurisdictions and local self-government nor the political-economic frameworks of social insurance, industrial relations, and economic interest representation had to be invented from scratch. In addition to the transfer of institutions, the *Neue Länder* had the extraordinary advantage of being able to draw on economic resources from the formerly West German and now all-German public budgets and social security funds.

In macroeconomic terms, the rapid integration of East Germany, with comprehensive economic protection, compensation, and improvement of the population's living standards, combined an extreme economic shock therapy with far-reaching insulation of the population from its consequences – in other words, with an anti-shock policy. Currency reform and privatisation were the shock element in the package. With the EMSU, the East German Mark was made equivalent to the Western Deutsche Mark on a parity basis. Wages and transfer incomes were also fixed in a one-to-one relationship. This amounted to an overnight appreciation of the local currency by about 400 per cent, rendering almost all East German economic activity instantly uncompetitive with Western products and services. Productivity levels in the East were estimated at only about 30 per cent of Western levels, and thus far too low to meet the new labour costs faced by Eastern German production units.

Although the purchasing power of the Eastern Germans had quadrupled as a consequence of currency reform, there was popular pressure for further improvements. With the December 1990 all-German election approaching, the federal government succumbed to the temptation to promise inter-regional wage equalisation within five years, thus promoting unrealistic popular aspirations. Government generated expectations that later yielded an endemic problem of widespread popular dissatisfaction with the material results of subsequent economic developments.

The costs of shock therapy combined with anti-shock guarantees began to surface in the rapid tailspin of the Eastern German economy that occurred throughout the 1990s. Growing imports, financed by huge income transfers from the West, caused the collapse of production in the East as well as a dramatic rise in unemployment.[2] Meanwhile, the newly installed privatisation agency operated by West German restructuring experts – the *Treuhandanstalt* – rapidly dismantled the state-owned industrial conglomerates, gave them a legal corporate governance framework, and weaned them off of soft credits in order to prepare them for privatisation. Many of these firms were forced to shrink dramatically or had to go out of business before or after privatisation. Even then, about half of the survivors had to be granted state subsidies for restructuring and new investments, at least in the early years. Overall, the gainfully employed labour force in Eastern Germany shrank from close to ten million in 1989 to barely six million within a couple of years. Employment in manufacturing nosedived from close to 50 per cent of the total to under twenty per cent, thus achieving decades of deindustrialisation in a Western capitalist economy in less than three years.

The painful restructuring and shrinkage of the Eastern German economy was followed by a giddy surge, with growth rates of up to 8 per cent (from a low floor) in the 1992-95 period – mostly fuelled by a giant building boom aided by Western public investments in infrastructure and residential renovation. But then, in the period between 1995 and 2000, the structural weakness of the *Neue Länder* economy asserted itself again, with sluggish growth rates of only about half of the already modest Western levels. In 2001, the Eastern economy shrank by one half of one per cent. Even generous investment incentives had been unable to compensate for the comparative disadvantage inflicted on the Eastern economy by the EMSU. Because currency union had removed devaluation as an option to restore Eastern competitiveness, Eastern German firms could not cover the huge increase in wages and social contributions – which far exceeded productivity – through price increases or reductions in the cost of factor inputs.[3] At the macroeconomic level, this produced extraordinarily high unemployment and a need for ever-higher fiscal transfers from West Germany, resulting in very large budget deficits. At the microeconomic level, federal and state governments were compelled to engage in industrial policy. The macro and microeconomic policies adopted in response to the Eastern crisis were inconsistent with the practices that had traditionally been pursued under the auspices of the German model.

Soon after unification, unemployment in the East grew to a level twice as high as that of West Germany – not taking into account the substantial share of the former East German labour force that was sent into early retirement, had withdrawn from the labour market, or took part in public retraining programmes. At almost 20 per cent from 1996 on (23 per cent including hidden unemployment), Eastern German rates exceeded those of all Central European countries. This extreme unemployment – resulting both from the wave of deindustrialisation and from higher labour market participation among East German women – constitutes Eastern Germany's basic political-economic problem. On the one hand, the only proper way of improving the macroeconomic situation (technically speaking) is through lower wages, lower tax rates, and more flexibility in the labour market and in state regulation. On the other hand, politicians in both the East and the West are experiencing strong pressure to call for the final closure of the remaining East-West income gap of 15 per cent. While Eastern German voters are demanding the full equalisation of all living conditions, economically sound policies lack sufficient public support. The much-lamented consequences are the ongoing migration of skilled younger people[4] and more than one million unoccupied apartments in the East.

In order to compensate for the extensive layoffs in industry and agriculture, huge transfer payments were directed to the East. Popular pressure demands that they continue until the GDP per capita approaches the Western level. Meanwhile, labour productivity has risen to 78 per cent of the West

German level, but due to high unemployment, Eastern domestic production per capita remains at only two thirds of the Western level. Transfers and new debts of between 75 and 100 billion euros per annum finance Eastern Germany's high consumption. The 'borrowed' share of Eastern Germany's prosperity thus amounts to one third of the total of investment and consumption. Cumulative total net financial transfers from the West between 1990 and 2002 have reached 800 billion euros.[5] Much of this was invested in subsidised employment – above all, in the still over-staffed public sector.

One striking indicator of over-staffing is the proportion of wage income to regional GDP. This amounts to 112 per cent of its Western equivalent, even though the average Eastern individual wage is only 77 per cent of the West German level.[6] The most conspicuous consequence of Eastern Germany's sponsored prosperity is thus the escalation of public debt. As a percentage of total GDP, Germany's state debt rose from 41.5 per cent in 1991 to 61.5 per cent in 1997. Correspondingly, interest payments increased from 11.4 per cent of the budget in 1991 to 18.9 per cent in 1999.[7] In 2002 and 2003, the federal government was unable to confine the budget shortfall to the 3 per cent ceiling fixed in the EU Stability Pact. Since unification, German macroeconomic policy has developed a propensity toward persistent counter-cyclical deficit financing.

Is there no way out of this economic malaise? Now an integral part of Germany, the *Neue Länder* lack autonomous macroeconomic control. Because all the important variables are externally controlled, only regional wage levels remain available for intervention. Early on in the unification process, the suggestion that lower Eastern wages would trigger migration to the West helped legitimise the high-wage policy of (Western-controlled) trade unions and employers' associations, although the underlying presumption lacked empirical evidence.[8] Since then, because of electoral imperatives, parties and state governments have found it increasingly difficult to resist the pressure for interregional wage equalisation. Proposals to make wages match the low level of labour productivity definitely seem unfeasible.[9] In 2002, the re-elected Red-Green coalition government promised a stepwise equalisation of wages in the public sector until 2007 – of course, at the expense of the number of available jobs.[10]

The Results of Unification—a Mixed Blessing

Comparing Eastern Germany's present situation with the state of the late GDR, one can easily see that the Eastern economy has made tremendous progress. Although the period of thoroughgoing restructuring at company level is over, the economy as a whole continues to be subject to favourable structural change due to high investments in infrastructure and human capital. The share of its competitive sectors in the GDP keeps growing at the expense of inefficient traditional sectors. Forces of employment growth now appear to counterbalance those of decline. The number of firms going out of business, on the one hand, appears to offset the number of new investments on the other. But while a competitive economy is emerging, its size is still too small given the volume of labour supply.

When we examine Eastern Germany in comparative context, there is more reason for satisfaction. Life has improved in almost every aspect, and far more so than in such countries as Poland or the Czech Republic. But this improvement does not translate into subjective satisfaction, because the reference is West Germany, not other post-communist countries. Because of their quest for 'full compensation', when real average incomes amount to only 85 per cent of Western levels, many East Germans feel they are being treated as second-class citizens.

Even extraordinary levels of financial compensation for the departure from a socialist economy did not protect the German federal government from Eastern discontent. Exuberant early West German promises about East-West equalisation, together with Eastern ideological-cultural residues of socialism and resentment against income differences, have combined to turn most political issues into matters of social justice that make interregional relations almost appear to be a class conflict between 'the rich' and 'the poor.' Although 'post-unification dissatisfaction'[11] manifests itself above all in injured self-esteem, its common denominator – as well as the only feasible remedy – appears to be monetary. This constitutes the political pole of a fundamental dilemma. Whereas the macroeconomic situation demands patience and self-restraint on the part of the Eastern Germans, the political debate – in both the new and the old *Länder*

– is subject to the logic of party competition with its strong incentive to trigger unrealistic expectations. All vote-seeking parties (including the liberal FDP) try to benefit from the resulting dissatisfaction with the achieved levels of distributive justice. Consequently, the governments of all five new *Länder* remain strong advocates of continuing the sponsored Eastern prosperity achieved through resource transfer from West Germany for an indefinite period of time.

THE MICROECONOMICS OF UNIFICATION AND MODEL GERMANY

The operation of the West German model relied on labour market institutions facilitating sectoral and national wage bargaining concertation, led by large companies, but compatible with the needs of most small and medium-sized enterprises. Such institutions were supplemented by contribution-based social insurance systems configured around protecting the standard of living of families supported by a single male breadwinner. That arrangement fed back positively into the employment system. By granting high levels of earnings-related compensation for labour market risks such as unemployment, it encouraged workers to make human capital investments in skills specifically valuable to a single industry or a single employer – for example, through vocational education.

As other articles in this volume show, the conditions that supported these arrangements have eroded throughout Germany. But in East Germany, such conditions were absent from the beginning and could not be created out of thin air by government in the 1990s. German unification therefore hastened the nationwide erosion of the German model. In this section, I will address the relevant issues one by one and then consider how federalism – as a potential technique to dissociate policies in Eastern and Western states – has helped or hindered efforts to address the unique problems of unification.

Wage Concertation

In the era of post-war growth, industry-wide peak-level bargaining between centralised employers' representatives and union representatives succeeded in organising a social class compromise. These negotiations resulted in the moderation of nominal wage increases, peaceful and predictable industrial relations for business and rising real wages for labour. The principle beneficiaries of the compromise were the very large, export-oriented German manufacturing companies that maintained high profitability and international competitiveness by pegging sectoral wages to the average conditions of firms in their sector. Furthermore, national wage leadership by the most export-oriented metal engineering sector throughout much of the post-war era ensured that unions and employers in the domestically-oriented sectors could not ratchet up wages in ways that would endanger the international competitiveness of German business. Large firms also accepted institutions of 'co-determination' through factory level works councils and firm level workforce representation on company supervisory boards. Small and medium-sized, mostly privately held businesses – an important ingredient of the West German growth and export machine – could swallow peak-level arrangements as long as domestic and international markets kept growing and did not require them to respond to tougher competitive environments with flexibility in the deployment of capital and labour.

The system of industry-wide peak-level wage bargaining was extended to Eastern Germany just at the time when small and medium-sized companies felt increasingly hard-pressed to accommodate such agreements. Moreover, Eastern Germany lacked resourceful, large and profitable corporations in the aftermath of the dramatic de-industrialisation effected by the shocks of monetary union and privatisation under the *Treuhandanstalt's* regime of dismembering and downsizing the old socialist holding companies and selling off the remaining marginally viable, but generally unprofitable bits. Nonetheless, the first peak-level collective agreement negotiated by trade unions and employers' associations in 1991 resulted in a substantial wage increase despite generally low labour productivity. Consequently, firms either ignored the agreement or faced economic disaster. Although about 80 per cent of Eastern enterprises – comprising almost 60 per cent of all wage earners – ignored the wage settlement, it set the standard for what union representatives advertised as 'fair' remuneration.

Because of the collapse of industry-wide wage contracts in the East, the unions began to tolerate firm-specific wage and working time agreements. So-called ‘opening and hardship clauses’ were introduced in collective agreements to improve factor flexibility. Innovative ‘experimentalism’[12] became a standard means of coping with the rigidities of supra-firm level collective agreements vis-à-vis the global competition.[13] While tight regulations were finally loosened in the West, belated institutional learning had little impact on the much poorer economic situation in the East. A key ingredient of Model Germany could not develop firm roots in the *Neue Länder*.

Wage Bargaining, Mittelstand *and Industrial Policy*

The institutional bias of German industrial wage bargaining in favour of large firms became dysfunctional for another reason as well. As early as the 1980s, large companies changed from being centres of job creation and instead became machines for high productivity growth through the insertion of capital-intensive, labour-saving technology and subcontracting with components manufacturers situated in low-wage countries. Innovative technology, new products and the rapid rise of business-related and private services fuelled a revival of small and medium-sized enterprises. Centralised industrialrelations did nothing to nurture the take-off of small and medium-sized companies in Eastern Germany. Moreover, the imposition of Western regulatory codes on an economic landscape in which only the massive creation of small companies could solve the problem of unemployment stifled factor flexibility and the entrepreneurial freedom required to stimulate the growth of small companies. While the federal government attended to the fate of the large, run-down socialist conglomerates, only a handful of members of parliament or representatives of business associations were campaigning to bring about a *Mittelstand*-friendly environment with effective incentives for venture capital and new entrepreneurs.

De-industrialisation and the collective bargaining system stifled the early emergence of a critical ingredient of the German System – an infrastructure of intermeshed medium-sized, competitive and export-oriented businesses. This deviation from the German model led policymakers to adopt another deviation that reinforced economic rigidity and failure to adapt to new challenges: a defensive interventionist industrial policy. Expensive subsidies were paid to save as many jobs in the existing industrial plants as possible. Federal and state governments targeted subsidies primarily to areas in the 'old cores' of East German industry, where the shock of monetary union and marketisation had created particularly high unemployment. Because such policies consumed a large share of the disposable financial industrial aid, regions with a higher potential for growth in terms of human capital or infrastructure were left with too few incentives to attract a large volume of investments.[14] Clinging to an outmoded concept of industrial policy, governments proved unable to resist short-term labour market considerations. Thus, huge amounts of investment capital, both public and private, were allocated in inefficient ways.

The overall picture of state-subsidised investment is mixed at best. A telling example is the reconstruction of the GDR's chemical industry complex around the town of Bitterfeld. According to a promise made by Chancellor Kohl, the equivalent of 25 billion euros from federal and EU funds was marshalled to rebuild the run-down production sites. Several billion were given to the French investor Elf-Aquitaine, which is said to have redistributed a considerable share of the subsidy as bribes. A similar subsidy went to Dow Chemical, on the order of no less than 1.2 million euros for each of 1,800 jobs retained. Nonetheless, the unemployment rate in the state of Sachsen-Anhalt continues to stagnate at 20 per cent. Another famous case is the fate of the 'saved' company *Zeiss Jena*, one of the few high-tech firms of the former GDR. Instead of reconstructing the unprofitable site, the company's CEO, Lothar Späth (a former Prime Minister of *Baden-Württemberg*) dismantled the Jena-based workshop and stripped away nearly all of its workforce. At the same time, almost 2 billion euros in public subsidies were spent for the acquisition of already profitable firms in West Germany.

Overall, during the first decade after unification, policy makers paid little attention to issues of structural reform, such as the creation of viable medium-sized businesses. Macroeconomic problems left little time for them to consider microeconomic developments. The high debt generated by German unification became entangled in the imperatives of downsizing public budgets in accordance with the

Maastricht criteria for European Monetary Union. Minimal attention was paid to reconsidering the financial and social consequences of the unification process.

It was not until the mid-1990s that the debate over a renewal of Germany's institutional order resurfaced. Even then, as other contributions to this volume show, only meek initiatives were undertaken to revive economic growth. Little attention was paid to the special structural problems of Eastern Germany. If anywhere, the accomplishments of reform after 1998 were concentrated in the area of 'post-materialist' issues such as environmental sustainability, citizenship and minority rights – all areas in which national rather than regional Eastern German constituencies guided the calculations of politicians.

Managing Risk through Social Insurance

As a result of the rapid de-industrialisation in Eastern Germany, full coverage of its population by the same health care, pension and unemployment entitlements as their Western counterparts was bound to lead to large revenue shortfalls. In order to pre-empt protests, the federal government had refrained from using unification as an opportunity to reform and retrench German social insurance benefits, and instead extended full coverage to all East Germans. As an immediate consequence, citizens in the East enjoyed a sudden increase in the quality of services and the level of income transfers. Whereas in 1990, pensioners in the East had received only 29 to 37 per cent of standard Western pension amounts, pension levels had risen to 79 per cent of Western levels five years later.[15] Because benefit disbursements raced ahead of payroll tax receipts, employees' and employers' social security taxes had to be increased to 20.3 per cent of gross wages in 1997.

In the health care system, an analogous rise in expenses was triggered not only by the extension of benefits to Eastern Germans, but also by institutional transfer from West Germany. The East German *Polikliniken*, with teams of salaried doctors working together in ambulatory care facilities, were a comparatively cost-efficient form of 'managed care'. With Eastern German doctors split over whether to keep this system or adopt the more expensive West German system of private medical practice – and with the federal Minister of Health remaining apparently neutral – the Western doctors' special interest associations succeeded in extending the Western system after carrying out a massive campaign among East German doctors. Instead of leaving the issue to Western organised self-interest, the federal government could have strengthened its own and the public health care funds' position by adopting *Polikliniken* as a 'managed care' pillar of the German medical system. Failure to do so contributed to further cost escalation in the German health care system, evidenced by an increase in payroll taxes for health insurance from 12.6 per cent in 1990 to 14.2 per cent in 2002.

The collapse of the East German labour market in the aftermath of the currency shock contributed to deficits in the German welfare state, not only due to a surge of early retirees that had been forced out of the labour market and were compensated by generous pensions. There also was the drain of Eastern German unemployment benefits and retraining measures on the German unemployment insurance system. Whereas many regard the overall results of the publicly funded labour market policies as 'a crushing disappointment',[16] the payroll tax for unemployment insurance rose from 4.3 per cent in 1990 to 6.5 per cent in 1995.

As Leibfried and Obinger report in this volume, the cumulation of all these expenses made German payroll taxes rise to record levels – from 35.6 per cent in 1990 to almost 42 per cent in 2002. The ensuing rise in labour costs further hurt the competitiveness of German business. Eastern Germans became beneficiaries of wage income replacement rates that had been set in the early 1970s, at a time when the single wage-earner family was still the norm. But in the 1990s, gainful employment by both men and women was the norm in Eastern Germany, even more so than in the West. Hence, Western benefits schemes translated into extremely high family compensations and weakened incentives for the beneficiaries to re-enter the labour market except for the lure of high wage rates. At the same time, because of the significance of high compensation levels for a large proportion of the Eastern German population, any attempt at reducing their generosity would be political suicide for vote-seeking politicians. Nevertheless, it is clear that high payroll taxes and benefits drive up German labour costs and undercut efforts to stimulate growth and employment.[17]

Education System

Most citizens regarded the transfer of West German educational institutions to the new *Länder* as a more or less self-evident matter, and consequently, the issue did not gain much public attention. Of course, there were occasional misgivings because of the continued employment of GDR schoolteachers who were once required to display strong Communist beliefs. Apart from this, however, the new Eastern German institutions of primary, secondary and tertiary education replicate their Western counterparts. Even the old Western controversy about the proper organisation of secondary education––separated into three streams according to pupils' differing academic talents, or united as a comprehensive school for all children regardless of abilities—was carried over into the East. The only exceptional feature of Eastern educational institutions remained the almost complete coverage of kindergartens for pre-school children. General conformity to the Western model can also be seen in the system of firm-based and state-organised vocational training.

Although the transfer of the Western education system to the East may not be spectacular, it serves as yet another example of an area where the East adopted institutions just as they ceased to be unambiguously advantageous even in the West. Since 1990, signals indicating the declining performance of Germany's secondary schools and its vocational training and university systems have been frequent. Had it not been for the challenge of unification, the weakening performance of the West German educational system would have made it onto the political agenda earlier than it actually did, when the process of imposing the old Western education system on its socialist alternative had finally come to an end.

Vocational education has long been a part of the German education system that seemed particularly indispensable for the proper operation of the German model. As Mayer and Hillmert indicate in this volume, efforts have been made to expand the menu of vocational education tracks to include new occupations, but these efforts have been timid. Most of the 344 approved occupations are still defined by the sectoral and technological structures of the past. Some aspects of the system were already outmoded on the eve of unification. About two thirds of all apprentices are trained for occupations in the shrinking sectors of manufacturing and *Handwerk*. At the same time, the system has failed to match employers' increasing demands for young people with broad basic competencies and special training in information technology and business related services. Even Eastern Germany's pressing need for jobs in innovative and growing business sectors has not been enough to trigger an adaptation of the system to its changing environment.

While the slow speed of reform in the system of vocational training appears to be a by-product of meso-level corporatist decision-making, the performance deficits attributed to Germany's universities – inability to train students in new, highly marketable professions, long duration of degree programs and effective time to completion, mediocre research productivity of university faculties – stem from the interaction between the fiscal and organisational interests of the *Länder* administrations in governing their own university sectors and the self-interests of the corporate groups involved in the university system: professors, students and administrators. Limited self-governance on the part of the universities keeps a system in place in which all groups block change in order to preserve their entrenched privileges and material benefits. The *Länder* are unwilling to give universities more autonomy and responsibility, keeping control over admissions, faculty appointments, courses of study and degree requirements. Corporate groups inside the university block any change that would generate more competition for funds and status recognition among students, professors, faculties and entire universities. In turn, weak exposure of all of these groups to competition discourages innovators who might propose new professional curricula or avenues of research. Both the rewards for successful innovation as well as the punishments for failure in the pursuit of excellence are ineffectual. Universities have therefore seen little reason to adapt to the demands of external labour markets.

The inefficacy of the university system became particularly manifest when Chancellor Schröder came up with an unusual proposal: Since the universities had failed to train a sufficient number of information technology specialists, immigration laws should be relaxed to allow software experts from India and elsewhere to fill the available jobs. Although the debate on this subject was lively, consequences for the reorganisation of higher education were slow in coming. Such changes tend to be prompted by new Europe-wide agreements to organise higher education more efficiently in order to improve the comparability and equivalence of university certificates across Europe. Exactly the same slow pace of reform may result from the debate that has followed Germany's extremely low ranking in the *Programme for International Student Assessment (PISA)*, a comparative survey of the school achievements of 15-year-old pupils organised by the OECD.[18]

The causes of the education system's declining performance are well known. They are representative of Germany's institutional conservatism, which is rooted in the anti-competitive predilections of occupational status groups as well as *Länder* governments. As Leibfried and Obinger argue in this volume, the Social Democratic-Christian welfare state in Germany has channelled funds away from the formation of new human capital to the care of holders of spent human capital. In 1999, Germany's overall public expenditures for education were slightly below the OECD average at 4.35 per cent, although overall social expenditures were near the top of the scale.

To make matters worse, the influence of occupational interest groups and political parties over education policy has biased the structure of expenditure and the educational governance regime away from the pursuit of excellence. Only the upper stratum of secondary education and the partly outmoded system of vocational training receive adequate funds because they enjoy sufficient external business backing or the attention of powerful status interests in the teaching profession. Furthermore, resource allocation favours teachers' and administrators' salaries at the expense of investments in buildings, teaching resources and media. The PISA survey demonstrates that the lower stratum of secondary and the whole of primary education are neglected both in funding and in management. As a result, the education system fails to provide the economy with a sufficient number of labour market entrants who are adequately prepared to thrive in a knowledge economy.[19] Not only the main political parties – which are beholden to powerful corporate interests dominated by people who care more about retirement and health care than about new human capital formation – but also the *Länder* governments, in whose jurisdiction much of educational reform would be located, lack the political incentives to develop a long-term investment perspective for education. Instead, they have treated educational and research budget lines as targets for fiscal austerity measures.

Federalism in Unified Germany

The logic of German federalism rests upon the notion of decentralised multi-level decision-making. But rather than providing a national framework for a market preserving federalism that enables sub-national units to compete with each other to find the most productive and democratically accepted innovative public policies, German *cooperative federalism* prescribes a complex web of interdependent decision-making that requires a broad consensus both at the national and the state level in order to enact change. Thus, the system handicaps reform initiatives emanating either from the centre or from the individual states. German federalism fragments jurisdictions, but does not create autonomy for bold initiatives. If innovation requires a consensual process involving both the states and the federal government, then the smallest common denominator among the many veto players determines the ceiling for reform efforts.

Unification enhanced the fragmentation of subnational geographic jurisdictions in Germany. Although the GDR's new political elite had the option of joining the Federal Republic as a single additional *Land*, they chose to re-found five rather small *Länder* with a total of 14.5 million citizens that mirror the heterogeneous structure of the West. Germany now has eleven *Länder* with less than three million citizens each. Furthermore, the entry of the new states into the federation creates a new divide that cross-cuts the existing partisan and regional divisions in the Upper House of the German parliament, the *Bundesrat*. Here, majorities of the state governments can block federal policy initiatives in the many social and economic policy areas for whose governance the constitution prescribes cooperative federalism.

Cooperative federalism not only constrains the federal government but diminishes its control over public budgets as well. In accordance with the constitutional mandate to bring about 'equality of living conditions in the federation',[20] a substantial share of tax revenues is being redistributed from the wealthier to the poorer states. Because of the resulting high level of equalisation among individual state governments' tax receipts (*Länderfinanzausgleich*), the system has relieved the states from competing with one another for a more attractive business environment or more efficient public services. In particular, states and regions with aging traditional industrial sectors are tempted to free-ride on the prosperity of their luckier or pluckier neighbours.

For the new Eastern German states, becoming equal partners in the system of horizontal revenue redistribution in the mid-1990s has therefore been a double-edged sword . On the one hand, the comparatively poor Eastern states gained access to badly needed resources which they were unable to acquire through taxes or loans. On the other hand, however, a permanent role as recipients of other states' financial largesse has suspended the need for Eastern state governments to re-organise social services and public infrastructure in ways that match expenditures to internal revenues in the foreseeable future. In fact, the Eastern *Länder* are banding together to preserve or extend the federal system of fiscal redistribution in their favour.

The resulting system of power sharing in Germany creates a strong bias in favour of the status quo[21] – accompanied by fiscal irresponsibility at the *Land* level, since sub-national jurisdictions are quite autonomous in their debt management. As a consequence, the federal government is forced to choose its fiscal policy within the boundaries of freedom left by the *Länder* after they have chosen their policies. Cross-cutting all of this are the political party interests of the *Länder* and federal governments. Since hardly a year goes by when state elections do not take place – and the loss of state election might impinge on the capacity of the federal government to shepherd its legislation through the upper house of the parliament – decision-making in the *Bundesrat* tends to generate not only fierce geographically-based distributional conflict but also partisan divides motivated by state and federal politicians' desire to win elections.

UNIFICATION AND PUBLIC OPINION

Is public opinion potentially a force that may counteract the political-economic reform blockages in Germany that have been exacerbated by national unification through the transfer of Western institutions and the further entrenchment of organised interests? In other words, could the intensified crisis of Model

Germany cause a shift in public opinion that would, in turn, weaken the capacity of institutions and organised interests to resist innovation? Empirical evidence suggests instead that unification shifted the balance of public opinion toward more support for current German welfare state policies as well as for the status of organised interests in policy formation, especially that of the labour unions.

The achievement of unification after only a brief period of negotiations was facilitated by the complementarity of two sets of interests. The Western elite's interest in institutional continuity was a perfect match for the Easterners' desire to swap the miserly socialist system of social security for the much more generous welfare state of a leading OECD country. When faced with the East German citizens' expressed approval of an encompassing and re-distributive welfare system, the proponents of unification refrained from retrenching and refashioning the existing German welfare state. Surveys throughout the 1990s have illustrated that underlying this social policy preference is a continued strong popular support for the socialist concepts of equality, desert, and redistribution in Eastern Germany. Even seven years after unification, an 83 per cent majority of Eastern Germans considered socialism a good idea if implemented properly. When asked to choose between two basic values, no less than 75 per cent gave priority to the value of equality over the value of freedom. During the same time period, the explicit preference for a socialist-type redistributive welfare state declined only slightly, from 76 per cent to 68 per cent. These figures put the Eastern Germans somewhat, though not dramatically, ahead of West German public opinion. In a survey conducted in the West in 1996, while only a 26 per cent minority of respondents endorsed socialist values, here, too, 51 per cent preferred equality over freedom. 61 per cent even identified socialism 'fully' or 'rather' as 'a good idea that was carried out badly'.[22]

Empirical evidence overwhelmingly indicates that the Eastern Germans' predominantly socialist sense of distributive justice translates into extraordinary levels of support for the status quo of the German welfare state. The organisation and experience of unification has reinforced the normative base of an unsustainable welfare state. The federal government always faces a majority opposing social reforms and, in particular, cuts in benefits. In 1997, when public budgets and social insurance funds were already overburdened by financial transfers to the East, a two-thirds majority of German citizens were reported to oppose any change in existing entitlements. Only a tiny minority of 12 per cent in the West and 1 per cent in the East were willing to accept cuts.[23] A four-country survey on welfare state reform conducted in March 2000 found that Eastern Germans were the least willing to consider a reform of the pay-as-you-go public pension system by inserting a funded component. This response put the Eastern Germans' support of the national status quo slightly ahead of the Spanish support level, and more substantially ahead of that of the French, Italian, and West German respondents.[24] Eastern Germans were also significantly more willing than West Germans to call for a further extension of the welfare state through higher taxes.[25] The accession of East Germany thus broadened the majorities unwilling to consider far-reaching social policy reforms.

Support for comprehensive redistributive social policies and support for labour unions mutually reinforce each other. After having survived the mild economic liberalism of the West German centre-right government in the 1980s without much harm, German unions managed to extend their domain to the GDR even before unification. As strong supporters of the welfare state status quo, of equal pay and of substantial expenditures on active labour market policies, they soon won the broad acceptance of Eastern blue and white-collar employees. Although union density has fallen steadily since 1991, the unions have remained the unquestioned representative of the Eastern skilled full-time employees in traditional industries such as manufacturing, construction, and – above all – public administration and social services.

The unions' image as standard bearers of the 'common good', combined with the prevailing socialist conceptions of distributive justice in Eastern Germany, effectively protected them from having to shoulder responsibility for high levels of unemployment in the East and increasing unemployment in the West. The unions successfully presented themselves as victims rather than co-authors of the persistent labour market malaise. Their privileged position in public opinion permitted them to act as defenders of the institutional order and to reject concessions within the framework of a proposed 'social pact' to benefit the unemployed. The refusal of German unions to make wage and social policy sacrifices for the sake of boosting employment stands in contrast to union conduct in post-communist Eastern Europe – as well as to that of unions in a number of European Union countries, which had to reduce public deficits in order to qualify for participation in the European monetary union. Only in a climate of intensifying public dismay about the state of German public finances, further economic decline, and the inability of the returning Red-Green coalition to propose a comprehensive reform policy after the September 2002 election, did German labour unions began to rethink their position and tolerate a labour market reform bill that passed the legislature in the winter of 2002/03. But with the extension of the unreformed West German welfare state to Eastern Germany an accomplished fact, a full array of reforms will now be much harder to engineer politically than it would have been ten years earlier.

CONCLUSION

The international situation in 1989/90 – together with the institutional and electoral imperatives of the West German political elites – explains the hurried and wholesale transfer of West German institutions to Eastern Germany during the unification process. With the benefit of hindsight, we can see that this pattern of unification has contributed to the weakening performance of the German political economy. Had international circumstances and domestic power relations been different, the elites might have seized upon unification as an opportunity to reform the basic parameters of the German institutional fabric. Now, after the turn of the millennium, the political elites find themselves in a situation in which this reform has become more urgent, but also even harder to achieve.

The opportunity costs of sticking to the status quo are rising as well. Past strategies for choosing a middle road between the Scandinavian social democratic welfare state and the Anglo-Saxon liberal residual welfare state may now no longer be feasible.[26] The cumulation of performance problems – among them, the generous extension of the Western welfare state to Eastern Germany – may now call for a market-liberal retrenchment of institutions and policies. But German political preferences and beliefs may change slowly enough to make this a long, drawn-out, incremental process. In this situation, the proposal to shift policy jurisdictions to the *Länder*, release them from the strictures of cooperative federalism, and unleash policy experimentation and innovation at the subnational level is gaining credibility. As long as path-breaking policy changes at the federal level are unlikely, granting individual states the right to greater policy-making autonomy might be a useful detour on the way to improved economic performance.[27] Needless to say, even this institutional change presupposes an intensified sense of crisis among the population and the political elites – one that makes them perceive doing nothing as more dangerous than engaging in some modest experimentation.

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