



An Economic Model at the Age 60: Path Changes or Path Dependences?

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Structure

1. Background
2. Path Dependence vs Path Change
3. A Sketch on Important Recent Debates
4. Path Change due to Recent Reforms?
5. Conclusions

Background (1)

- In the 1950s and 1960s the rest of the world has associated west Germany with remarkable prosperity and stability.
- West Germany provided comparatively high wage rates, low levels of inequality and a good (un)employment performance.
- In other words: “**Prosperity for all**” (L. Erhard).
- Academics saw the secrets for success, above all, in
 - a **stability-oriented economic policy** with respect to inflation, wages etc. based on ‘sound’ institutions (limited but strong state, independent central bank, strong competition policy, freedom of collective bargaining etc.),
 - a strategy of developing **export markets outside the domestic economy** (to gain form scale economies etc.)
 - a reliance on comparatively high levels of **human capital and skilled labour**.

Background (2)

- This approach created a comparative advantage in moderate-technology products in manufacturing industries with comparatively high-price products albeit with a competitive price-quality ratio.
- This strategy was able to **compensate for the small size of Germany's domestic market**.
- It proved very successful in the early post-war decades.
- However, even before the economic strains of reunification, **cracks** were beginning to appear.
- Already in 1988, *The Economist* described the 1980s as a **“decade of economic underperformance”** for west Germany.
- Many economists think that lower growth and persistently higher unemployment after 1973 are the consequence of **too much focus on the word “social”** which hampered ec. activity.

Background (3)

- The slowdown had to do, above all, with Keynesian demand management experiments in the 1970s, institutional changes with mixed results only in the 1980s and new challenges including globalisation since the 1990s.
- Above all, however, the political commitment to a social market economy opened the door for the growing **redistribution** of income property rights.
- The beneficiary was often the electorally strong middle class and the well-organised groups. This led to growing subsidies. Taxes and regulatory burdens on producers were raised. Parliament and governments became increasingly involved with specific outcome-orientated interventions.
- The policy **focus on the competitive legal institutional order was diluted** already before unification. This became worse due to unification before it became a catalyst for change. ⁵

Background (4)



Economic Policy

For decades, the German economy has been the locomotive driving the European train. Now it seems more like the **caboose**.

Germany Stalled

By Bruce Stokes

AMBURG, Germany—On a sunny Sunday afternoon this summer,

Source: National Journal, 15-7-2006

Path Dependence vs. Path Change (1)

Examples Path Dependence

- German innovation system geared to diversified quality production => rather strong resilience of social system of production.
- German market weakness for highly innovative products.
- German economy geared to trade surpluses and with few exceptions current account surpluses.
- Strong role of certain principles (e.g. price stability) and the way to achieve them (independent institutions); ongoing struggles with respect to distributive issues.

Path changes

- Comparatively difficult due to proportional voting system and many other veto points; system changing reforms after crises.

Path Dependence vs. Path Change (2)

Table 1. Institutional Framework of the German Economy

Social system of production	Production system	Legal system	Social Security system	Research landscape
Finance system: All-purpose banks (since the 1870s/1934/1952) <i>[1945–1952]</i>	Diversified quality production (since late 19 th century)	Corporate governance: Joint-stock Corporation Act (since 1884/1897/ 1931/1937/1965)	Health insurance (since 1883)	University research (since 18 th century/1819/1920/1969)
Economic Interest Intermediation: Primacy of the economy (since 1879/1897); Primacy of the state <i>[since 1931/1949/1933]</i>	Growing share of nonmaterial value creation (in the 20 th cen- tury)	Regulated competition (since 1897/1923/1958) <i>[1945–1951]</i>	Accident insurance (since 1884)	Unity of research and teaching (since 1810)
Intercompany system: “Corporatist coordination” (since 1879/1918/1934/ 1936 /1949/1951) <i>[1945–1951]</i>	Dualism: Diversified quality production and standardized mass production <i>[1933/1941–1970s]</i>	Commercial law (since 1897)	Old-age insurance (since 1889/1911/ 1948/1957/1972/ 1992)	Applied research/technical colleges since end of 19 th century/1949 Fraunhofer Society of Industrial Engineer- ing (since late 19 th century)
Industrial relations: Codetermination (since 1890/1905/1916/1920/1951/ 1952/1976) <i>[1933–1947]</i>	Crisis in standardized mass production <i>[1970s]</i>	Civil law (since 1900)	Unemployment insurance (since 1927)	
Qualification system: Dual system of vocational training (since 1869/1897/1938/1969) <i>[1945–1951]</i>	Diversified quality production with mainly nonmaterial value creation (since the 1970s)	Welfare state: Socially equitable freedom of con- tract (since 1919/1949)	Long-term nursing care insurance (since 1995)	Cutting-edge research (Kaiser Wilhelm Society since 1911/1920/Max Planck Society since 1946/1948)

Note: Years in parentheses express continuity in change; years in *italicized, boldfaced brackets* express discontinuities.

Source: ©Werner Abelshauser.

Recent Debates (1)

Two issues are currently at the heart of debates on the German economy:

➤ How has the (eastern) German economy changed 20 years after fall of the Berlin wall? How successful was the reform process?



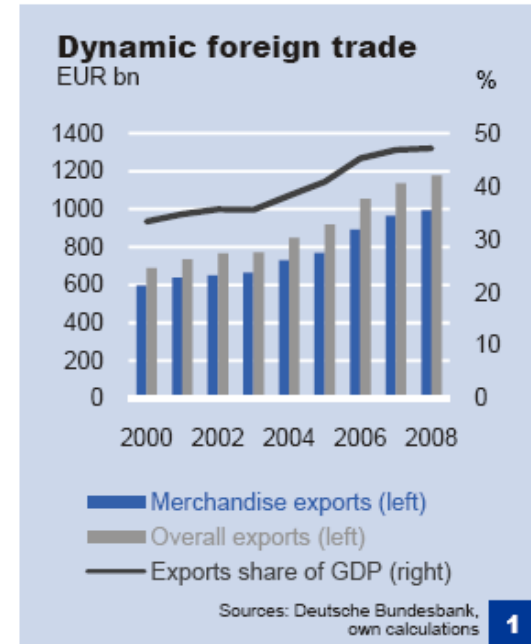
➤ Has the German economy become ‘unbalanced’ as a result of the adjustment process? **Alternatively:** May this be just regarded as the adjustment process towards a sustainable ‘national business model’?

Recent Debates (2)

The British-German perspective:

- In the past, Germany was seen as being among the strongest economies in Europe, and the UK as one of the weakest. The situation has been reversed in more recent years until 2007/8.
- The reversal of fortunes occurred in the wake of unification in 1990. It may be partly explained by difficulties in the transition from central-planning in the east to a market-based economy.
- Germany's recent economic performance has been helped by **very strong exports**. As argued before, traditionally Germany was a strong exporter.

Recent Debates (3)



(Source: DB Research 2009)

Recent Debates (4)

The strength of German exports in the traditionally most important export branches – engineering, chemicals, vehicle production and electro-technology – contrasts with the UK experience of persistent deficit on the current account of the balance of payments.

The UK Foreign Office released archive material on 1989/1990 recently which shows how hard the then prime minister Margaret Thatcher fought to prevent German unification from happening, or at least to slow it down. This is made clear by what she told her ambassador in West Germany Sir Christopher Mallaby on Nov. 1, 1989.

Thatcher recommends him not to worry too much about European geopolitics and instead to focus on the more pressing concern of massive and persistent German trade surpluses, based on an under-valued D-Mark and subsidies to German industry.

Recent Debates: Stocktaking of German Unification (1)

- The interim balance is mixed despite € 1.3 trillion of transfers since 1990, though prosperity has clearly increased over what it was in the GDR.
- Disposable household income has risen, on average, from just 60% of the western level in 1991 to 78.6% in 2007.
- **Improvements** also with respect to housing situation, spread of consumer durable goods, expanded infrastructure, environmental protection.
- **Deficits:** Per capita GDP in the east is only 71% of that in the west; since 1997 the gap to the western *Länder* has only been closed very slightly; **East Germans still consume more than they produce, a gap of at least 20%.**

Recent Debates: Stocktaking of German Unification (2)

- **Structural differences:** Businesses in the east are smaller, on average, than those in the west; corporate headquarters tend not to be located in the east => high value added (e.g. R&D) tend not to be located in the east; the export-income ratio is also comparatively low.
- With **unemployment** in eastern Germany in 2008 at nearly 15%, with 1.12 million jobless persons, this was clearly below the 2003 peak (1.62 million, 20%). Nevertheless, unemployment is still twice as high as in western Germany.
- **Causes of the persistence of problems:** still the after-effects of currency-conversion, wage adjustments etc.
- Still controversial among adherents to the Social Market Economy if alternative reforms would have been better.

Germany's rising export dependence until 2008: leading to an unbalanced economy? (1)



(Sources: Economist)

Germany's rising export dependence until 2008: leading to an unbalanced economy? (2)



(Sources: Economist)

Common Denominator: Labour Market Reforms (1)

- After a decade of low economic growth in Germany, the economic upswing in Germany had reached the labour market.
- Some economists cheer: “It appears that the recent Hartz reforms have moved equilibrium unemployment downwards, for the first time in decades” (Burda/Wyplosz 2009).
- For many economists, the main causes of high unemployment appear no longer controversial.
- “The majority of economists is convinced that the incentives to work that are grounded in the institutional framework of the labor market are responsible for unemployment.” (Dovern/Meier 2006).
- These German economists explain their point of views more thoroughly:

Common Denominator: The Role of Labour Market Institutions (2) - A Typical Statement

“This view is well founded, both theoretically and empirically. On the theoretical side, it is based on the new labor market theories, in particular the insider-/outsider theory and the efficiency wage theory. ... According to these theories, regulations that benefit workers such as high replacement rates or high employment protection laws will increase wage demands and actual wages of workers and lead to a wage level that is above the market clearing level. Combined with a neoclassical model of labor demand, this implies that unemployment increases as a result of these regulations. This unemployment will be ‘structural’ as opposed to cyclical; it will not vanish in the long run. ... On the empirical side, these theories are well grounded, too. The key to returning to full employment, thus, lies with correcting the incentives that result from the institutional framework of the labor market and the social security system.”

Common Denominator (3): Standardised Unemployment Rates (% of labour force)

	1960-1969	1970-1979	1980-1989	1990-1999	2000-2006
Germany	0.8	2.4	5.8	7.6	8.4
Specific Countries in Comparison:					
UK	1.8	4.2	9.5	8.0	5.0
USA	4.8	6.2	7.3	5.8	5.1
Sweden	1.7	2.0	2.6	7.2	6.0

Source: Burda/Wyplosz 2009

Likely Causes of Recent Labour Market Improvements (1)

- Report of the **Hartz Commission** aimed at increasing the efficiency of the fed. employment service.
- **Agenda 2010** involved reforms of the unemployment insurance and unemployment aid system, i.e. cuts in the duration of benefit in the insurance program and a reduction in the benefit levels and qualification for the follow-up needs-based program.
- Agenda 2010 included further supply-side incentives as a deregulation of the **temporary help** sector, a liberalisation of **marginal employment**, the institution of **stricter work requirements** and better possibilities to **combine wages with benefits** (subsidised wages).

Likely Causes of Recent Labour Market Improvements (2)

- However, opposition waived important elements of Agenda 2010 reforms after 2005 under the black-red coalition.
- Above all, this included prolonging the **eligibility period** for elderly unemployed and the imposition of **mandatory minimum wages** in several sectors, but not a national one up until now.
- These measures most likely make the **labour market more rigid**, not more flexible according to several studies.
- Nonetheless, the **net effects** of reforms are in the liberalising direction and employment enhancing.

Likely Causes of Recent Labour Market Improvements (3) – A Quote Again

“The German labor market has experienced many far-reaching changes in recent years as a result of various labor market reforms. There has been a move away from the policy of rewarding non-work, a deregulation of temporary work, and an efficiency-enhancing organizational reform of the employment administration. For the first time in three decades, structural unemployment has been successfully reduced. The labor market reforms have been accompanied with consistent corporate restructuring efforts and appropriate union wage moderation. Altogether, this has led to a drop of 1.5 million in the number of unemployed since 2005, and an increase in the participation rate of older people by almost 15 percentage points to a total of 50 per cent”.

Source: Zimmermann et al. 2008

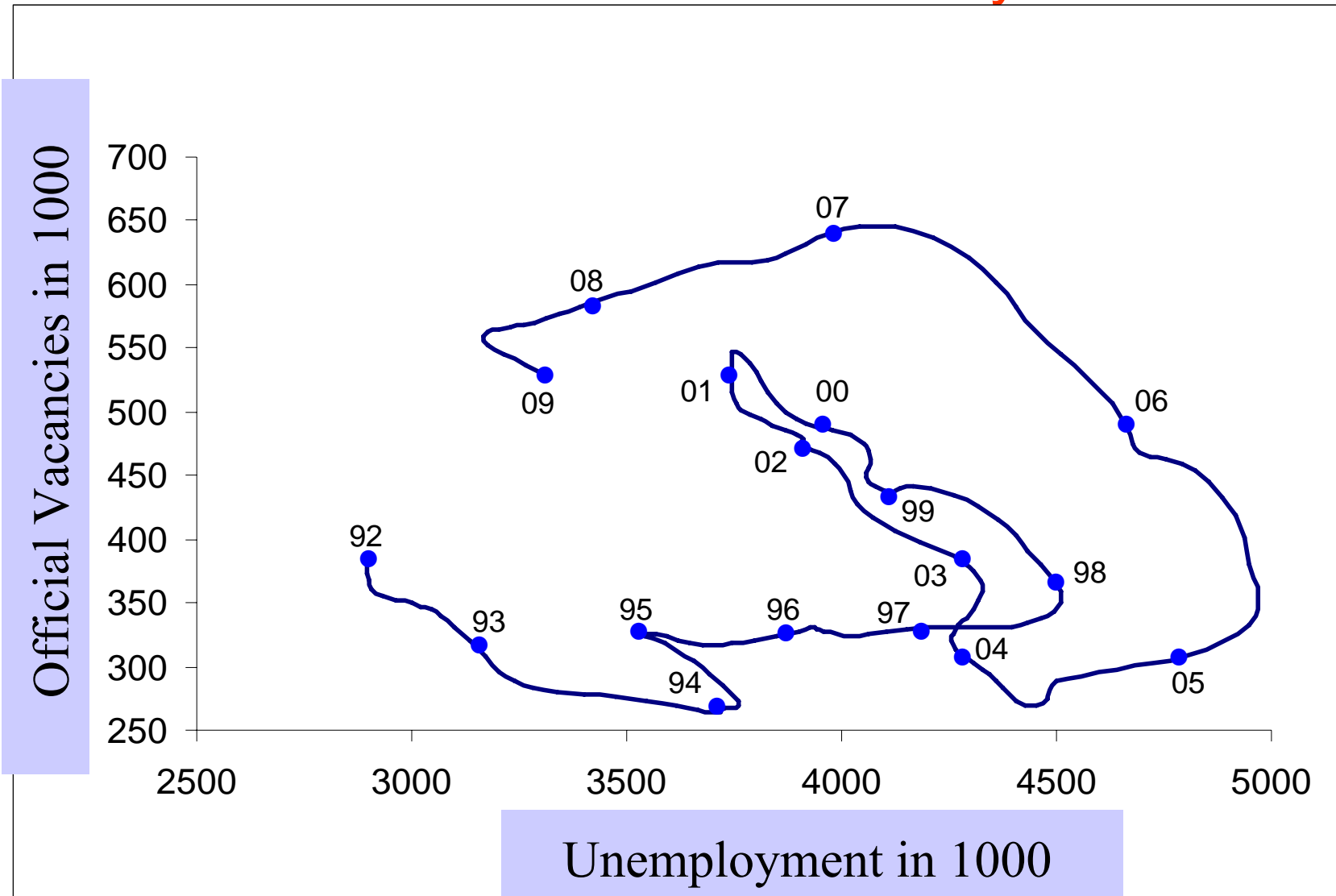
Likely Causes of Recent Labour Market Improvements (4)

- What are the expected **economic transmission channels**?
- The goal was to **increase the supply of labour**. This generally implies lower wages, increasing labour demand, and more output, especially for an open economy with an export exposure now well above 40%.
- **Evidence** has emerged that recent reforms (and general trends) have indeed increased labour supply.
- As was to be expected, the **supply of vacancies**, i.e. the demand for labour, responds positively to a reduction in the reservation wage of workers in wage bargaining.

Evidence (1): The Empirical Beveridge Curve in Germany

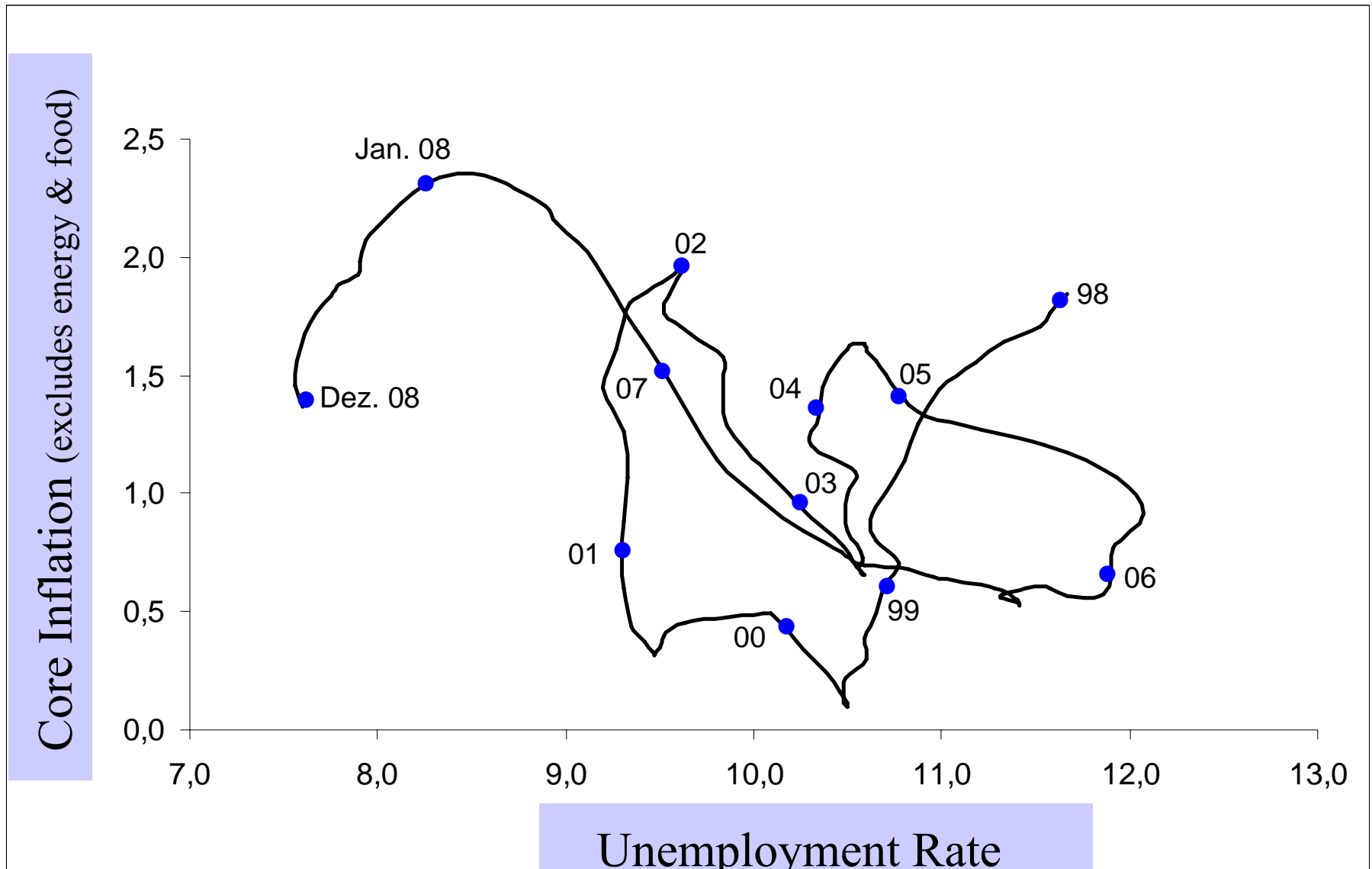
- At a **given** so-called **Beveridge curve**, firms offer fewer jobs and unemployment is higher in recessions. The vacancy rate rises and the unemployment rate declines in economic expansions.
- The **position** indicates the longer-run efficiency of job-matching in labour markets.
- A Beveridge Curve **far away from the origin** indicates a **bad functioning labour market**.
- The Curve seemed to shift away from the origin in the mid-1970s, suggesting increasing inefficiency.
- In contrast to other countries, the return to the earlier position has been slow, if at all, until recently.

Evidence (2): The Empirical Beveridge Curve in Germany



Source: IAB 2009

Evidence (3): The Empirical Phillips Curve in Germany



Source: IAB 2009

Evidence (4): Evidence from Estimates of Equilibrium Unemployment

	1970	1980	1990	2000	2008
Germany	3.3	4.4	6.9	7.3	7.1
Specific Countries in Comparison:					
UK	2.7	4.1	8.0	5.6	5.3
USA	5.5	6.5	5.6	5.0	4.6
Sweden	1.5	1.9	2.2	4.8	4.8

Source: Burda/Wyplosz 2009

Controversies: one example (1)

- Despite these hints that appear to support the employment-enhancing and **path-changing results** of the Hartz and Agenda 2010 reforms, controversies remain.
- Mainstream economists thought that German private **consumption which was almost flat** since 2001 could rise due to labour market reforms. That could have put overall growth on a broader basis.
- This was not fulfilled as a result from an increase of the **VAT-tax** and dramatically **higher oil and commodity prices** particularly in mid-2008.
- Therefore, some economists argue in favour of a **wage policy that maintains or increases purchasing power** (e.g. ILO 2009). The German mainstream economist advocates, however, **wage moderation** in order to save and increase employment.

Controversies: one example (2)

- There are, however, alternative ways to increase consumption and aggregate demand as well. Richard Freeman (2007) argues:

“If part of Germany’s economic problem is inadequate consumption spending, which seems a reasonable deduction, then **family policies** that marketize household production and increase fertility offer a way to spur additional private consumption”.

He goes on:

“Radical work incentives oriented around family policy – greater investment in day care, separate taxation of family earners, longer school days of after school programs – can activate female labour supply further.”

Outlook (1): What are the options?

- **The current financial crisis should have a cathartic impact on the financial sector, but there is a risk that responses will overshoot, ie we might get overall more regulations.**
- **Roll-back scenario:** One can call into question the often beneficial effects of employment-promoting reforms. **Very likely inefficient and not very helpful also to the poor!**
- **Move on with liberalisation measures ‘without a human face’:** **Politically and economically unreasonable!**
- **“Efficient Social Market Response”:** **Spreading the risks and opportunities more evenly between the core employees and the peripheral workers** by improving education outcomes, improving incentives to work for long term unemployed and particularly women with better family policies also to revive internal demand.

Outlook (2): What are the options?

“We already have the conceptual approach we need to set up intelligent rules to which all market actors have to adhere and that will foster transparency, credibility and trust. ...

- We need to revive a culture of stability and responsibility in business.
- Individual incentives should reward long-term success, prevent short-term excesses and punish inordinate risk-taking.
- We know that sticking to rules on competition, state aid and trade shelters the long-term gains from competition and trade from short-term protectionist and interventionist reflexes.
- Our social systems should shield market participants from the consequences of market upheaval – but not at the expense of market flexibility.
- These principles are the leitmotifs of the Social Market Economy on which Germany’s rise after World War II was built.”

(Karl-Theodor zu Guttenberg, former Economics Minister, Financial 26-3-09).

Thank you very much for your attention!

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